AWARE INC /MA/
Form 10-Q
November 04, 2005

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED SEPTEMBER 30, 2005

COMMISSION FILE NUMBER 000-21129

AWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

40 MIDDLESEX TURNPIKE, BEDFORD, MASSACHUSETTS, 01730

(Address of Principal Executive Offices)
(Zip Code)

(781) 276-4000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2). YES X NO

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

Indicate the number of shares outstanding of the issuer's common stock as of October 21, 2005:

CLASS	NUMBER OF SHARES OUTSTANDING
Common Stock, par value $0.01 per share	23,171,143 shares

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AWARE, INC.
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PART I. FINANCIAL INFORMATION
ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS
AWARE, INC.
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(UNAUDITED)

	SEPTEMBER 30, 2005	D
ASSETS		

Current assets:		
Cash and cash equivalents	$13,374	
Short-term investments	23,143	
Accounts receivable, net	3,606	
Inventories	54	
Prepaid expenses and other current assets	656	
Total current assets	40,833	
Property and equipment, net	8,063	
Investments	1,001	
Other assets, net	322	
Total assets	$50,219	

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	$451	
Accrued expenses	144	
Accrued compensation	939	
Accrued professional	257	
Deferred revenue	105	
Total current liabilities	1,896	
Stockholders' equity:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized, none outstanding	-	
Common stock, $.01 par value; 70,000,000 shares authorized; issued and outstanding, 23,171,143 in 2005 and 22,908,918 in 2004	232	
Additional paid-in capital	78,721	
Accumulated deficit	(30,630)	
Total stockholders' equity	48,323	
Total liabilities and stockholders' equity	$50,219	

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

AWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONT SEPTEMB
	2005	2004	2005

Revenue:			
Product sales	$2,417	$977	$4,163
Contract revenue	1,920	2,556	5,061
Royalties	750	1,028	2,770
Total revenue	5,087	4,561	11,994
Costs and expenses:			
Cost of product sales	157	198	279
Cost of contract revenue	826	676	2,384
Research and development	2,487	2,511	7,400
Selling and marketing	721	521	2,064
General and administrative	644	634	1,940
Total costs and expenses	4,835	4,540	14,067
Income (loss) from operations	252	21	(2,073)
Interest income	309	143	798
Income (loss) before provision for income taxes	561	164	(1,275)
Provision for income taxes	-	-	-
Net income (loss)	$561	$164	($1,275)
Net income (loss) per share - basic	$0.02	$0.01	($0.06)
Net income (loss) per share - diluted	$0.02	$0.01	($0.06)
Weighted average shares - basic	23,116	22,784	23,027
Weighted average shares - diluted	25,168	22,837	23,027

The accompanying notes are an integral part of the consolidated financial statement

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AWARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2005	20
Cash flows from operating activities:		
Net loss	($1,275)	
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	460	

Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	(536)	
Inventories	89	
Prepaid expenses	(239)	
Accounts payable	90	
Accrued expenses	389	
Deferred revenue	(10)	
Net cash used in operating activities	(1,032)	
Cash flows from investing activities:		
Purchases of property and equipment	(219)	
Other assets	(339)	
Sales of investments	20,028	
Purchases of investments	(13,388)	
Net cash provided by investing activities	6,082	
Cash flows from financing activities:		
Proceeds from issuance of common stock	842	
Net cash provided by financing activities	842	
Increase in cash and cash equivalents	5,892	
Cash and cash equivalents, beginning of period	7,482	
Cash and cash equivalents, end of period	$13,374	

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

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

A) BASIS OF PRESENTATION

The accompanying unaudited consolidated balance sheet, statements of operations, and statements of cash flows reflect all adjustments (consisting only of normal recurring items) which are, in the opinion of management, necessary for a fair presentation of financial position at September 30, 2005, and of operations and cash flows for the interim periods ended September 30, 2005 and 2004.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a complete presentation of our financial position, results of operations and cash flows, in conformity with generally accepted accounting principles. We filed audited financial statements which included all information and footnotes necessary for such presentation for the three years ended

December 31, 2004 in conjunction with our 2004 Annual Report on Form 10-K.

Auction rate securities in the amount of $17.2 million at December 31, 2003 and $12.5 million at September 30, 2004 have been reclassified from cash and cash equivalents to short-term investments in the statement of cash flows for the nine months ended September 30, 2004 to conform to the 2005 financial statement presentation. Accordingly, the statement of cash flows for the quarter ended September 30, 2004 reflects the gross purchases and sales of these securities as investing activities rather than as a component of cash and cash equivalents.

The results of operations for the interim period ended September 30, 2005 are not necessarily indicative of the results to be expected for the year.

B) INVENTORY

Inventory consists primarily of the following (in thousands):

	SEPTEMBER 30, 2005	DECEMBER 31, 2004
Raw materials........................	$54	$143

C) COMPUTATION OF EARNINGS PER SHARE

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

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS EN SEPTEMBER 30
	2005	2004	2005
Net income (loss)................................	$561	$164	($1,275)
Weighted average common shares outstanding........	23,116	22,784	23,027
Additional dilutive common stock equivalents......	2,052	53	-
Diluted shares outstanding	25,168	22,837	23,027
Net income (loss) per share - basic..............	$0.02	$0.01	($0.06)
Net income (loss) per share - diluted............	$0.02	$0.01	($0.06)

For the three month periods ended September 30, 2005 and 2004, options to purchase 202,167 and 3,234,406 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

For the nine month periods ended September 30, 2005 and 2004, potential common stock equivalents of 1,789,280 and 227,801, respectively, were not included in the per share calculation for diluted EPS, because we had net losses and the effect of their inclusion would be anti-dilutive. For the nine month periods ended September 30, 2005 and 2004, options to purchase 1,876,167 and 294,167 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

D) STOCK-BASED COMPENSATION

We grant stock options to our employees and directors. Such grants are for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. As permitted by SFAS No. 123, "Accounting for Stock-Based Compensation", we account for stock option grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44 ("FIN 44"), "Accounting for Certain Transactions Involving Stock

Compensation." Accordingly, we have adopted the provisions of SFAS No. 123 through disclosure only.

No stock-based employee compensation cost is reflected in net income (loss), as all options granted under those plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant. The following table illustrates the pro forma effect on net loss and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148 to stock-based employee compensation (in thousands, except per share data):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS EN SEPTEMBER 30
	2005	2004	2005
Net income (loss) - as reported..................	$561	$164	($1,275)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards.........................	593	2,044	9,042
Net loss - pro forma	($32)	($1,880)	($10,317)
Basic income (loss) per share - as reported.......	$0.02	$0.01	($0.06)
Basic loss per share - pro forma.................	$0.00	($0.08)	($0.45)
Diluted income (loss) per share - as reported.....	$0.02	$0.01	($0.06)
Diluted loss per share - pro forma...............	$0.00	($0.08)	($0.45)

The fair value of options on their grant date was measured using the Black-Scholes option pricing model. Key assumptions used to apply this pricing model are as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS EN SEPTEMBER 30	
	2005	2004	2005	
Average risk-free interest rate..................	4.04%	3.51%	3.93%	
Expected life of option grants...................	5 years	5 years	5 years	
Expected volatility of underlying stock...........	82%	94%	84%	
Expected dividend yield..........................	-	-	-	

E) BUSINESS SEGMENTS

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

The Company sells its products and technology to domestic and international customers. Revenues were generated from the following geographic regions (in thousands):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
United States...............................	$3,447	$3,202	$7,123	$7,
Germany.....................................	1,578	1,121	3,493	3,
Rest of World...............................	62	238	1,378	1,
	$5,087	$4,561	$11,994	$11,

F) RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 123 (revised 2004), Share-Based Payment ("SFAS 123R"). This Statement is a revision to SFAS 123, ACCOUNTING FOR STOCK-BASED COMPENSATION, and supersedes APB Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES. SFAS 123R requires the measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render service. The planned effective date of SFAS 123R was to be the first interim or annual reporting period that began after June 15, 2005. In April

2005, the effective date was extended for calendar year companies until January 1, 2006. We expect that the adoption of SFAS 123R will have a significant impact on our results of operations. We do not expect the adoption of SFAS 123R to impact our overall financial position.

ITEM 2:
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

SOME OF THE INFORMATION IN THIS FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE SUBSTANTIAL RISKS AND UNCERTAINTIES. YOU CAN IDENTIFY THESE STATEMENTS BY FORWARD-LOOKING WORDS SUCH AS "MAY," "WILL," "EXPECT," "ANTICIPATE," "BELIEVE," "ESTIMATE," "CONTINUE" AND SIMILAR WORDS. YOU SHOULD READ STATEMENTS THAT CONTAIN THESE WORDS CAREFULLY BECAUSE THEY: (1) DISCUSS OUR FUTURE EXPECTATIONS; (2) CONTAIN PROJECTIONS OF OUR FUTURE OPERATING RESULTS OR FINANCIAL CONDITION; OR (3) STATE OTHER "FORWARD-LOOKING" INFORMATION. HOWEVER, WE MAY NOT BE ABLE TO PREDICT FUTURE EVENTS ACCURATELY. THE RISK FACTORS LISTED IN THIS SECTION, AS WELL AS ANY CAUTIONARY LANGUAGE IN THIS FORM 10-Q, PROVIDE EXAMPLES OF RISKS, UNCERTAINTIES AND EVENTS THAT MAY CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THE EXPECTATIONS WE DESCRIBE IN OUR FORWARD-LOOKING STATEMENTS. YOU SHOULD BE AWARE THAT THE OCCURRENCE OF ANY OF THE EVENTS DESCRIBED IN THESE RISK FACTORS AND ELSEWHERE IN THIS FORM 10-Q COULD MATERIALLY AND ADVERSELY AFFECT OUR BUSINESS.

RESULTS OF OPERATIONS

PRODUCT SALES. Product sales consist primarily of revenue from the sale of hardware and software products. Hardware products include ADSL test and development systems, modules, and modems. Software products consist of standard off-the-shelf software products for biometric, medical imaging and digital imaging applications, as well as DSL test and diagnostics software.

Product sales increased 147% from $1.0 million in the third quarter of 2004 to $2.4 million in the current year quarter. As a percentage of total revenue, product sales increased from 21% in the third quarter of 2004 to 48% in the current year quarter. For the nine months ended September 30, product sales increased 29% from $3.2 million in 2004 to $4.2 million in 2005. As a percentage of total revenue, product sales increased from 27% in the first nine months of 2004 to 35% in the corresponding period of 2005.

For the three month period, the dollar increase was due to a $1.5 million increase in revenue from the sale of software products, partially offset by a decrease in revenue of $0.1 million from the sale of hardware products. For the nine month period, the dollar increase was due to a $1.9 million increase in revenue from the sale of software products, partially offset by a decrease in revenue of $1.0 million from the sale of hardware products.

CONTRACT REVENUE. Contract revenue consists primarily of license and engineering service fees that we receive under agreements with our customers to develop ADSL (including ADSL2, ADSL2plus or VDSL2) chipsets.

Contract revenue decreased 25% from $2.6 million in the third quarter of 2004 to

$1.9 million in the current year quarter. As a percentage of total revenue, contract revenue decreased from 56% in the third quarter of 2004 to 38% in the current year quarter. The dollar decrease was due to lower license fee revenues associated with the delivery of licensed technology and engineering services.

For the nine months ended September 30, contract revenue decreased 10% from $5.6 million in 2004 to $5.1 million in 2005. As a percentage of total revenue, contract revenue decreased from 47% in the first nine months of 2004 to 42% in the corresponding period of 2005. The dollar decrease was due to lower license fee revenues associated with the delivery of licensed technology and engineering services.

While we believe that the transition to ADSL2plus technology in the ADSL industry and the recent establishment of a VDSL2 standard by the International Telecommunications Union increase the value proposition of our technology, both existing and prospective ADSL chipset licensees have continued to be reluctant to begin new development projects given: (i) generally weak worldwide economic conditions, (ii) a difficult and uncertain environment in the semiconductor and telecommunications industries, and (iii) intense ADSL chipset competition and falling chipset prices. During the last several years, customers and potential customers cautiously evaluated new chipset projects or delayed or cancelled projects in the face of such conditions.

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

Royalties decreased 27% from $1.0 million in the third quarter of 2004 to $0.8 million in the current year quarter. As a percentage of total revenue, royalties decreased from 23% in the third quarter of 2004 to 15% in the current year quarter. For the nine months ended September 30, royalties decreased 9% from $3.0 million in 2004 to $2.8 million in 2005. As a percentage of total revenue, royalties decreased from 26% in the first nine months of 2004 to 23% in the corresponding period of 2005.

Our royalty revenue comes predominantly from ADSL chipset sales by Analog Devices, Inc. ("ADI"), and Infineon Technologies AG ("Infineon"). Despite steady growth of worldwide ADSL subscribers over the last several years, the availability of ADSL chipsets from a number of suppliers and intense competition among those suppliers has caused chipset prices to steadily decline. We are uncertain how the transition to ADSL2plus and VDSL2 will impact our customers in the near term, how quickly sales of our customers' chipsets will increase and whether such increases will contribute meaningful royalties to us.

COST OF PRODUCT SALES. Since the cost of software product sales is minimal, cost of product sales consists primarily of the cost of hardware product sales. Cost of product sales decreased 21% from $198,000 in the third quarter of 2004 to $157,000 in the current year quarter. As a percentage of product sales, cost of product sales decreased from 20% in the third quarter of 2004 to 7% in the current year. This percentage decrease was primarily due to a lower proportion of hardware sales during the current quarter. In terms of dollars, the decrease in cost of product sales and the increase in product margin was primarily due to lower hardware product sales. The increase in product margin as a percent of product sales was primarily due to a larger proportion of software sales in the product sales revenue mix.

For the nine months ended September 30, cost of product sales decreased 62% from $730,000 in 2004 to $279,000 in 2005. As a percentage of product sales, cost of product sales decreased from 23% in the first nine months of 2004 to 7% in the corresponding period of 2005. This

percentage decrease was primarily due to a lower proportion of hardware sales during the nine month period. In terms of dollars, the decrease in cost of product sales and increase in product margin was primarily due to lower hardware product sales. The increase in product margin as a percent of product sales was primarily due to a larger proportion of software sales in the product sales revenue mix.

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

Cost of contract revenue increased 22% from $0.7 million in the third quarter of 2004 to $0.8 million in the third quarter of 2005. As a percentage of contract revenue, cost of contract revenue increased from 26% in the third quarter of 2004 to 43% in the current year quarter. For the nine months ended September 30, cost of contract revenue increased 19% from $2.0 million in 2004 to $2.4 million in 2005. As a percentage of contract revenue, cost of contract revenue increased from 35% in the first nine months of 2004 to 47% in the corresponding period of 2005.

For the three and nine month periods, the dollar increase in cost of contract revenue was primarily due to more customer projects in the three and nine month periods of 2005 as compared with 2004. Since our cost of contract revenue is based on the level of effort we expend on customer projects and the number of customer projects increased, cost of contract revenue increased as well.

RESEARCH AND DEVELOPMENT EXPENSE. Research and development expense consists primarily of salaries for engineers and expenses for consultants, recruiting, supplies, equipment, depreciation and facilities related to engineering projects to improve our broadband intellectual property offerings, as well as our software and hardware product technology.

Research and development expense was approximately $2.5 million in both the third quarter of 2004 and 2005. As a percentage of total revenue, research and development expense decreased from 55% in the third quarter of 2004 to 49% in the current year quarter. For the nine months ended September 30, research and development expense decreased 4% from $7.7 million in 2004 to $7.4 million in 2005. As a percentage of total revenue, research and development expense decreased from 65% in the first nine months of 2004 to 62% in the corresponding period of 2005.

For the nine month period the dollar decrease was from $0.3 million decreased spending resulting from a shift of engineers to customer projects, where spending is classified as cost of contract revenue. This shift occurred because we had more customer projects in 2005 than in 2004. The dollar decrease in spending was also attributable to $0.3 million lower depreciation expense. The dollar decreases were partially offset by a $0.4 million increase for chip design and tape out costs associated with our StratiPHY3 product.

Our research and development spending was principally focused on improving our ADSL, ADSL2 and ADSL2plus StratiPHY2+(TM) technology and chips, developing our VDSL2 StratiPHY3 technology and chips, developing test and diagnostics hardware and software and developing imaging and biometrics software.

SELLING AND MARKETING EXPENSE. Selling and marketing expense consists primarily of salaries for sales and marketing personnel, travel, advertising and promotion, recruiting, and facilities expense. Sales and marketing expense increased 38% in the current quarter compared with the corresponding quarter of 2004, and was approximately $0.5 million in the third quarter of 2004 and $0.7 million in the current year quarter. As a percentage of total revenue, sales and marketing expense increased from 11% in the third quarter of 2004 to 14% in the current year quarter. For the current nine months ended September 30, selling and marketing expense increased 15% and was approximately $1.8 million in 2004 and $2.1 million in 2005. As a percentage of total revenue, selling and marketing expense increased from 15% in the first nine months of 2004 to 17% in the corresponding period of 2005. For both the three and nine month periods, the dollar increases were mainly attributable to higher compensation costs.

GENERAL AND ADMINISTRATIVE EXPENSE. General and administrative expense consists primarily of salaries for administrative personnel, facility costs, bad debt, audit, legal, stock exchange and insurance expenses. General and administrative expenses were approximately $0.6 million in the third quarter of both 2004 and 2005. As a percentage of total revenue, general and administrative expense decreased from 14% in the third quarter of 2004 to 13% in the corresponding quarter of the current year. For the nine months ended September 30, general and administrative expenses were approximately $1.9 million in both 2004 and 2005. As a percentage of total revenue, general and administrative expenses were approximately 16% in the first nine months of 2004 and in the corresponding period of 2005.

INTEREST INCOME. Interest income increased 116% from $143,000 in the third quarter of 2004 to $309,000 in the current year quarter. For the nine months ended September 30, interest income increased 109% from $381,000 in 2004 to $798,000 in 2005. For the three and nine month periods, the dollar increase was due to higher interest rates earned on our cash and investment balances.

INCOME TAXES. We made no provision for income taxes in the first nine months of 2005 and 2004 due to net losses incurred. In 2002, we determined that due to our continuing operating losses as well as the uncertainty of the timing of profitability in future periods, we should fully reserve our deferred tax assets. As of September 30, 2005, our deferred tax assets continue to be fully reserved. We will continue to evaluate, on a quarterly basis, the positive and negative evidence affecting the realizability of our deferred tax assets.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2005, we had cash, cash equivalents, short-term investments and investments of $37.5 million, which represents a decrease of $0.7 million from December 31, 2004. The decrease was primarily due to $1.0 million of cash used in operations and capital expenditures of $0.5 million, partially offset by $0.8 million of proceeds from the exercise of employee stock options.

Cash used in operations in the first nine months of 2005 was primarily from operating losses. Capital spending was primarily related to the purchase of computer hardware and software, and laboratory equipment used principally in engineering activities, as well as expenditures related to the purchase of certain technology assets.

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At September 30, 2004, we had cash, cash equivalents, short-term investments and investments of $36.9 million, which represents a decrease of $2.0 million from December 31, 2003. The decrease is primarily due to $2.0 million of cash used in operations.

Cash used in operations in the first nine months of 2004 was primarily the result of operating losses and working capital requirements. Capital spending was primarily related to the purchase of computer hardware and software, and laboratory equipment used principally in engineering activities.

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

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 123 (revised 2004), Share-Based Payment ("SFAS 123R"). This Statement is a revision to SFAS 123, ACCOUNTING FOR STOCK-BASED Compensation, and supersedes APB Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES. SFAS 123R requires the measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render service. The planned effective date of SFAS 123R was to be the first interim or annual reporting period that began after June 15, 2005. In April 2005, the effective date was extended for calendar year companies until January 1, 2006. We expect that the adoption of SFAS 123R will have a significant impact on our results of operations. We do not expect the adoption of SFAS 123R to impact our overall financial position.

RISK FACTORS

We believe that the occurrence of any one or some combination of the following risk factors could seriously harm our business.

OUR QUARTERLY RESULTS ARE UNPREDICTABLE AND MAY FLUCTUATE SIGNIFICANTLY

Our quarterly revenue and operating results are difficult to predict and may fluctuate significantly from quarter-to-quarter. Because our revenue components fluctuate and are difficult to predict, and our expenses are largely independent of revenues in any particular period, it is difficult for us to accurately forecast revenues and profitability. When appropriate, we recognize contract revenues ratably over the period during which we expect to deliver technology and provide engineering services. While this means that contract revenues from certain current agreements are generally predictable, changes can be introduced by a reevaluation of the length of the development period, or by the termination of a contract. The initial estimate of this period is subject to revision as the product being developed under a contract nears completion, and a revision may result in an increase or decrease to the quarterly revenue for that contract. In addition, accurate prediction of revenues from new contracts or licensees is difficult

because contract negotiation is a lengthy process, frequently spanning a year or more, and the fiscal period in which a new license agreement will be entered into, if at all, and the financial terms of such an agreement are difficult to predict. Contract revenues also include fees for engineering services, which are dependent upon the varying level of assistance desired by licensees and, therefore, the revenue from these services is also difficult to predict.

It is also difficult for us to make accurate forecasts of royalty revenues. Royalties are recognized in the quarter in which we receive a report from a licensee regarding the shipment of licensed integrated circuits in the prior quarter, and are dependent upon fluctuating sales volumes and/or prices of chips containing our technology, all of which are beyond our ability to control or assess in advance.

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

- |X| market acceptance of broadband technologies we supply by semiconductor or equipment companies;
- |X| the extent and timing of new license transactions with semiconductor companies;
- |X| changes in our and our licensees' development schedules and levels of expenditure on research and development;
- |X| the loss of a strategic relationship or termination of a project by a licensee;
- |X| equipment companies' acceptance of integrated circuits produced by our licensees;
- |X| the loss by a licensee of a strategic relationship with an equipment company customer;
- |X| announcements or introductions of new technologies or products by us or our competitors;
- |X| delays or problems in the introduction or performance of enhancements or of future generations of our technology;
- |X| failures or problems in our hardware or software products;
- |X| delays in the adoption of new industry standards or changes in market perception of the value of new or existing standards;
- |X| competitive pressures resulting in lower contract revenues or royalty rates;
- |X| competitive pressures resulting in lower software or hardware product revenues;
- |X| personnel changes, particularly those involving engineering and technical personnel;
- |X| costs associated with protecting our intellectual property;
- |X| the potential that licensees could fail to make payments under their current contracts;
- |X| ADSL market-related issues, including lower ADSL chipset unit demand brought on by excess channel inventory and lower average selling prices for ADSL chipsets as a result of market surpluses;
- |X| regulatory developments; and
- |X| general economic trends and other factors.

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

WE EXPERIENCED NET LOSSES

We had a net loss during 2001, 2002, 2003, 2004 and the first nine months of 2005. We may continue to experience losses in the future if:

- |X| the semiconductor and telecommunications markets do not improve;
- |X| our existing customers do not increase their revenues from sales of chipsets with our technology;

- |X| new or existing customers do not choose to license our intellectual property for new chipset products; or
- |X| new or existing customers do not choose to use our software or hardware products.

WE HAVE A UNIQUE BUSINESS MODEL

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

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

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

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

Our business could be seriously harmed if:

- |X| we cannot obtain suitable licensees;
- |X| our licensees fail to achieve significant sales of chipsets or products incorporating our technology; or
- |X| we otherwise fail to implement our business strategy successfully.

THERE HAS BEEN AND MAY CONTINUE TO BE AN OVERSUPPLY OF ADSL CHIPSETS, AND THERE IS INTENSE COMPETITION FOR ADSL CHIPSETS, WHICH HAS CAUSED OUR ROYALTY REVENUE TO DECLINE

The royalties we receive are influenced by many of the risks faced by the ADSL market in general, including reduced average selling prices ("ASPs") for ADSL chipsets during periods of

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surplus. In 2000, 2001, and 2002, the ADSL industry had experienced an oversupply of ADSL chipsets and central office equipment. Excessive inventory levels led to soft chipset demand, which in turn led to declining ASPs. ASPs have also been under pressure because of intense competition in the ADSL chipset marketplace. As a result of the soft demand and declining ASPs for ADSL chipsets, our royalty revenue has decreased substantially from the levels we achieved in 2000. Price decreases for ADSL chipsets, and the corresponding decreases in per unit royalties received by us, can be sudden and dramatic.

Pricing pressures may continue during the remainder of 2005 and beyond. Our royalty revenue may decline over the long term.

WE DEPEND SUBSTANTIALLY UPON A LIMITED NUMBER OF LICENSEES

There are a relatively limited number of semiconductor and equipment companies to which we can license our broadband technology in a manner consistent with our business model. If we fail to maintain relationships with our current licensees or fail to establish a sufficient number of new licensing relationships, our business could be seriously harmed. In addition, our prospective customers may use their superior size and bargaining power to demand license terms that are unfavorable to us and prospective customers may not elect to license from us.

WE DERIVE A SIGNIFICANT AMOUNT OF REVENUE FROM A SMALL NUMBER OF CUSTOMERS

In 2002, 2003, 2004 and the first nine months of 2005, we derived 32%, 27%, 26% and 19%, respectively, of our total revenue from ADI and 15%, 17%, 28%, and 28% respectively, of our total revenue from Infineon. ADI and Infineon have developed many generations of ADSL chipsets based upon our technology. Our royalty revenue in the near term is highly dependent upon ADI's and Infineon's ADSL chipset market share and pricing. The ADSL market has experienced significant price erosion, which has adversely affected ADSL chipset revenues, which in turn has adversely affected our royalty revenue. To the extent that ADI or Infineon loses market share, is unable to transition its product to support new ADSL2 and ADSL2plus standards, or experiences further price erosion in its ADSL chipsets, our royalty revenue could decline.

OUR SUCCESS REQUIRES ACCEPTANCE OF OUR TECHNOLOGY BY EQUIPMENT COMPANIES

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

We also face the risk that equipment companies that elect to use integrated circuits that incorporate our technology into their products will not compete successfully against other equipment companies. Many factors beyond our control could influence the success or failure of a particular equipment company that uses integrated circuits based on our technology, including:

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- |X| competition from other businesses in the same industry;
- |X| market acceptance of its products;
- |X| its engineering, sales and marketing, and management capabilities;
- |X| technical challenges of developing its products unrelated to our technology; and
- |X| its financial and other resources.

Even if equipment companies incorporate chipsets based on our intellectual property into their products, their products may not achieve commercial acceptance or result in significant royalties to us.

OUR SUCCESS REQUIRES TELEPHONE COMPANIES TO INSTALL ADSL SERVICE IN VOLUME

The success of our ADSL licensing business depends upon telephone companies installing ADSL service in significant volumes. Factors that affect the volume deployment of ADSL service include:

- |X| the desire of telephone companies to install ADSL service, which is dependent on the development of a viable business model for ADSL service, including the capability to market, sell, install and maintain the service;
- |X| the pricing of ADSL services by telephone companies;
- |X| the transition by telephone companies to new ADSL technologies, such as ADSL2, ADSL2plus and VDSL2;
- |X| the quality of telephone companies' networks;
- |X| deployment by phone companies of fiber-to-the home or broadband wireless services;
- |X| government regulations; and
- |X| the willingness of residential telephone customers to demand ADSL service in the face of competitive service offerings, such as cable modems, fiber-based service or broadband wireless access.

If telephone companies do not install ADSL service in significant volumes, or if telephone companies install broadband service based on other technology, our business will 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, and we have a number of patents and pending patent applications. We also rely on a combination of trade secrets, copyright and trademark law and non-disclosure agreements to protect our unpatented intellectual property. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our technology without authorization.

As part of our licensing arrangements, we typically work closely with our semiconductor and equipment manufacturer licensees, many of whom are also our potential competitors, and provide them with proprietary know-how necessary for their development of customized chipsets based on our ADSL technology. Although our license agreements contain non-disclosure provisions and other terms protecting our proprietary know-how and technology rights, it is

possible that, despite these precautions, some of our licensees might obtain from us proprietary information that they could use to compete with us in the marketplace. Although we intend to defend our intellectual property as necessary, the steps we have taken may be inadequate to prevent misappropriation.

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

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

OUR BUSINESS IS SUBJECT TO RAPID TECHNOLOGICAL CHANGE

The semiconductor and telecommunications industries, as well as the market for high-speed network access technologies, are characterized by rapid technological change, with new generations of products being introduced regularly and with ongoing evolutionary improvements. We expect to depend on our ADSL technology for a substantial portion of our revenue for the foreseeable future. Therefore, we face risks that others could introduce competing technology that renders our ADSL technology less desirable or obsolete. Also, the announcement of new technologies could cause our licensees or their customers to delay or defer entering into arrangements for the use of our existing technology. Either of these events could seriously harm our business.

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

One element of our business strategy is to assume the risks of technology development failure while reducing such risks for our licensees. In the past, we have spent significant amounts on

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development projects that did not produce any marketable technologies or products, and we cannot assure you that it will not occur again.

WE FACE INTENSE COMPETITION FROM A WIDE RANGE OF COMPETITORS

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

As an intellectual property supplier to the semiconductor industry, we face intense competition from internal development teams within potential semiconductor customers. We must convince potential licensees to license from us rather than develop technology internally. Furthermore, semiconductor customers, who have licensed our intellectual property, may choose to abandon joint development projects with us and develop chipsets themselves without using our technology. In addition to competition from internal development teams, we compete against other independent suppliers of intellectual property. We anticipate intense competition from suppliers of intellectual property for ADSL.

The market for ADSL chipsets is also intensely competitive. Our success within the ADSL industry requires that ADSL equipment manufacturers buy chipsets from our semiconductor licensees, and that telephone companies buy ADSL equipment from those equipment manufacturers. Our customers' chipsets compete with products from other vendors of standards-based and ADSL chipsets, including Broadcom, Centillium, Conexant, ST Microelectronics and Texas Instruments.

ADSL services offered over copper telephone networks also compete with alternative broadband transmission technologies that use the telephone network as well as other network architectures. Alternative technologies for the telephone network include symmetric high speed DSL (also known as HDSL, SDSL and G.SHDSL), and very high speed DSL, also known as VDSL. These DSL technologies may be based on techniques other than those used by ADSL to transport high-speed data over telephone lines. While we are actively developing VDSL technology and products that meet new VDSL2 standards, we are not certain that we will be able to participate in future VDSL deployments. Alternative technologies that use other network architectures to provide high-speed data service include cable modems using cable networks, wireless solutions using wireless networks, and optical solutions using fiber optics technology. These alternative broadband technologies may be more successful than ADSL and we may not be able to participate in the markets involving these alternative technologies.

Many of our current and prospective ADSL licensees, as well as chipset competitors that compete with our semiconductor licensees, including Broadcom, Conexant, ST Microelectronics and Texas Instruments have significantly greater financial, technological, manufacturing, marketing and personnel resources than we do. We may be unable to compete successfully, and competitive pressures could seriously harm our business.

WE MUST MAKE JUDGMENTS IN THE PROCESS OF PREPARING OUR FINANCIAL STATEMENTS

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

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

OUR STOCK PRICE MAY BE EXTREMELY VOLATILE

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

|X| quarterly fluctuations in our operating results;
|X| changes in future financial guidance that we may provide to investors and public market analysts;

- |X| changes in our relationships with our licensees;
- |X| announcements of technological innovations or new products by us, our licensees or our competitors;
- |X| changes in ADSL market growth rates as well as investor perceptions regarding the investment opportunity that companies participating in the ADSL industry afford them;
- |X| changes in earnings estimates by public market analysts;
- |X| key personnel losses;
- |X| sales of common stock; and
- |X| developments or announcements with respect to industry standards, patents or proprietary rights.

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

OUR BUSINESS MAY BE AFFECTED BY GOVERNMENT REGULATIONS

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

ITEM 3:
QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

We do not use derivative financial instruments for speculative or trading purposes. As of September 30, 2005, we had $36.5 million in cash, cash equivalents and short-term investments that matured in twelve months or less. Due to the short duration of these financial instruments, we do not expect that an increase in interest rates would result in any material loss to our investment portfolio.

As of September 30, 2005, we had invested $1.0 million in long-term investments that matured in one to three years. These long-term securities are invested in high quality U.S. government securities. Despite the high quality of these securities, they may be subject to interest rate risk. This means that if interest rates increase, the principal amount of our investment would probably decline. A large increase in interest rates may cause a material loss to our long-term investments. The following table (dollars in thousands) presents hypothetical changes in the fair value of our long-term investments at September 30, 2005. The modeling technique measures the change in fair value arising from selected potential changes in interest rates. Movements in interest rates of plus or minus 50 basis points (BP) and 100 BP reflect immediate hypothetical shifts in the fair value of these investments.

	Valuation of securities given an interest rate decrease of		No change in interest rates	Valuation of sec given an intere increase
Type of security	(100BP)	(50 BP)		100 BP
Long-term investments with maturities of one to three years...	$1,015	$1,008	$1,001	$986

ITEM 4: CONTROLS AND PROCEDURES

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

PART II. OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

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

ITEM 6:
EXHIBITS

(A) EXHIBITS

Exhibit 31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

AWARE, INC.

Date: November 4, 2005

By: /s/ Michael A. Tzannes

Michael A. Tzannes, Chief Executive Officer

Date: November 4, 2005

By: /s/ Robert J. Weiskopf

Robert J. Weiskopf, Chief Financial Officer (Principal Financial and Accounting Officer)