

AWARE INC /MA/
Form 10-Q
July 28, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant To Section 13 Or 15(d) Of The
Securities Exchange Act of 1934**

For the quarter ended June 30, 2015

Commission file number 000-21129

AWARE, INC.
(Exact Name of
Registrant as
Specified in Its
Charter)

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

Incorporation or
Organization)

40 Middlesex Turnpike, Bedford, Massachusetts, 01730
(Address of Principal Executive Offices)
(Zip Code)

(781) 276-4000
(Registrant's

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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 NO

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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer”, “accelerated filer”, and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer 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

Indicate the number of shares outstanding of the issuer’s common stock as of July 22, 2015:

Class	Number of Shares Outstanding
Common Stock, par value \$0.01 per share	22,929,901 shares

AWARE, INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2015

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

	June 30,	December 31,
	2015	2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$44,513	\$ 43,985
Accounts receivable, net	4,821	3,619
Inventories	2	2
Deferred tax assets	189	168
Prepaid expenses and other current assets	1,093	401
Total current assets	50,618	48,175
Property and equipment, net	5,140	5,289
Investments	856	1,428
Long term deferred tax assets	737	804
Other assets	425	197
Total assets	\$57,776	\$ 55,893
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$147	\$ 258
Accrued expenses	938	820
Deferred revenue	2,836	2,352
Total current liabilities	3,921	3,430
Long-term deferred revenue	183	74
Commitments and contingent liabilities		
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 22,871,039 as of June 30, 2015 and 22,808,761 as of December 31, 2014	229	228

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Additional paid-in capital	104,487	103,756
Accumulated other comprehensive loss	(69)	(29)
Accumulated deficit	(50,975)	(51,566)
Total stockholders' equity	53,672	52,389
Total liabilities and stockholders' equity	\$57,776	\$ 55,893

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)

(unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Revenue:				
Software licenses	\$2,272	\$2,065	\$3,921	\$3,682
Software maintenance	1,278	1,152	2,431	2,197
Services	855	1,338	2,075	2,346
Hardware	-	2,048	-	4,681
Royalties	105	164	206	478
Total revenue	4,510	6,767	8,633	13,384
Costs and expenses:				
Cost of hardware	-	1,411	-	3,313
Cost of services	569	618	1,116	1,082
Research and development	1,439	1,400	2,874	2,679
Selling and marketing	1,064	981	2,036	1,839
General and administrative	961	975	1,746	1,779
Total costs and expenses	4,033	5,385	7,772	10,692
Operating income	477	1,382	861	2,692
Other income/(expense)	-	(59)	12	(59)
Interest income	33	52	74	139
Income before provision for income taxes	510	1,375	947	2,772
Provision for income taxes	191	510	356	1,026
Net income	\$319	\$865	\$591	\$1,746
Net income per share – basic	\$0.01	\$0.04	\$0.03	\$0.08
Net income per share – diluted	\$0.01	\$0.04	\$0.03	\$0.08
Weighted-average shares – basic	22,867	22,630	22,866	22,628
Weighted-average shares - diluted	23,029	22,837	22,958	22,769
Comprehensive income:				
Net income	\$319	\$865	\$591	\$1,746
Other comprehensive income (net of tax):				
Unrealized gains (losses) on available for sale securities	(48)	37	(40)	121

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Comprehensive income	\$271	\$902	\$551	\$1,867
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The accompanying notes are an integral part of the consolidated financial statements.

AWARE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30, 2015 2014	
Cash flows from operating activities:		
Net income	\$591	\$1,746
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	309	269
Stock-based compensation	242	322
Amortization of premium on investments	(5)	-
Deferred tax provision on other comprehensive income	21	(79)
(Gain)/loss on sale of investments	(12)	59
Changes in assets and liabilities:		
Accounts receivable	(1,202)	(1,312)
Inventories	-	1,538
Prepaid expenses and other current assets	(692)	338
Deferred tax assets	46	197
Accounts payable	(111)	(923)
Accrued expenses	118	170
Accrued income taxes	-	88
Deferred revenue	593	270
Net cash provided by (used in) operating activities	(102)	2,683
Cash flows from investing activities:		
Purchases of property and equipment	(68)	(101)
Sales of investments	529	1,432
Purchase of other assets	(320)	-
Net cash provided by investing activities	141	1,331
Cash flows from financing activities:		
Proceeds from issuance of common stock	22	68
Excess tax benefits from stock-based compensation	554	592
Payments made for taxes of employees who surrendered shares related to unrestricted stock	(87)	(92)
Net cash provided by financing activities	489	568
Increase in cash and cash equivalents	528	4,582
Cash and cash equivalents, beginning of period	43,985	72,660

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Cash and cash equivalents, end of period	\$44,513	\$77,242
Supplemental disclosure:		
Cash paid for income taxes	\$346	\$2
Non-cash transactions:		
Stock option receivables offset against proceeds from issuance of common stock	\$-	\$138

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

AWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Basis of Presentation. The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and notes necessary for a complete presentation of our financial position, results of operations and cash flows, in conformity with generally accepted accounting principles. We filed audited financial statements which included all information and notes necessary for such presentation for the three years ended December 31, 2014 in conjunction with our 2014 Annual Report on Form 10-K. This Form 10-Q should be read in conjunction with that Form 10-K.

The accompanying unaudited consolidated balance sheets, statements of income and comprehensive income, and statements of cash flows reflect all adjustments (consisting only of normal recurring items) which are, in the opinion of management, necessary for a fair presentation of financial position at June 30, 2015, and of operations and cash flows for the interim periods ended June 30, 2015 and 2014.

The results of operations for the interim period ended June 30, 2015 are not necessarily indicative of the results to be expected for the year.

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 \$44.5 million and \$44.0 million as of June 30, 2015 and December 31, 2014, respectively. We classified our cash equivalents of \$34.3 million and \$34.3 million as of June 30, 2015 and December 31, 2014 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 \$0.9 million and \$1.4 million of available-for-sale investments as of June 30, 2015 and December 31, 2014, respectively.

As of June 30, 2015, 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 June 30, 2015		
	Using:		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Corporate debt securities	\$856	\$ -	\$ -
Money market funds (included in cash and cash equivalents)	34,311		
Total	\$35,167	\$ -	\$ -

As of December 31, 2014, 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, 2014		
	Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Corporate debt securities	\$1,428	\$ -	\$ -
Money market funds (included in cash and cash equivalents)	34,339		
Total	\$35,767	\$ -	\$ -

Inventories. Inventories are stated at the lower of cost or net realizable value with cost being determined by the C) first-in, first-out (“FIFO”) method. Inventory balances at June 30, 2015 and December 31, 2014 were immaterial and consisted of spare parts.

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

	Three Months Ended June 30, 2015		Six Months Ended June 30, 2014	
	2015	2014	2015	2014
Net income	\$319	\$865	\$591	\$1,746
Shares outstanding:				
Weighted-average common shares outstanding	22,867	22,630	22,866	22,628
Additional dilutive common stock equivalents	162	207	92	141
Diluted shares outstanding	23,029	22,837	22,958	22,769

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Net income per share – basic	\$0.01	\$0.04	\$0.03	\$0.08
Net income per share - diluted	\$0.01	\$0.04	\$0.03	\$0.08

For the three month periods ended June 30, 2015 and 2014, options to purchase 54,034 and 821,838 shares of common stock were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

For the six month periods ended June 30, 2015 and 2014, options to purchase 54,034 and 821,838 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

E) **Stock-Based Compensation.** The following table presents stock-based employee compensation expenses included in our unaudited consolidated statements of comprehensive income (in thousands):

	Three Months Ended June 30, 2015		Six Months Ended June 30, 2014	
Cost of services	\$12	\$14	\$13	\$15
Research and development	26	34	27	37
Selling and marketing	4	6	5	6
General and administrative	179	239	197	264
Stock-based compensation expense	\$221	\$293	\$242	\$322

Stock Option Grants. We may grant stock options under our 2001 Nonqualified Stock Plan although we have not granted any stock options since the first quarter of 2012. When we grant stock options, we estimate their fair value using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. 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. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

Unrestricted Stock Grants. We also grant unrestricted shares of stock under our 2001 Nonqualified Stock Plan. 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 shares of unrestricted stock in 2015 and 2014 that affected financial results for the three and six month periods ended June 30, 2015 and 2014. These grants are described below.

2015 Grant. On March 26, 2015, we granted 152,000 shares of unrestricted stock to directors, officers and employees. Half of those shares were issued on July 1, 2015 and the remaining 76,000 shares will be issued shortly after December 31, 2015, provided each grantee is serving as a director, officer or employee on that date. The total stock-based compensation expense related to this grant is \$682,000, of which \$221,000 and \$236,000 was charged to expense in the three and six months ended June 30, 2015, respectively. We anticipate the remaining \$446,000 will be charged to expense ratably over the remaining two quarters of 2015.

2014 Grant. In March 2014, we granted 152,000 shares of unrestricted stock to directors, officers and employees. The shares were issued in two equal installments shortly after June 30, 2014 and December 31, 2014. We expensed the entire \$876,000 stock-based compensation expense related to this grant in 2014. We issued shares of common stock related to this grant as follows: i) 58,769 net shares of common stock were issued in early July 2014 after employees surrendered 17,231 shares for which we paid \$113,000 of withholding taxes on their behalf; and ii) 56,804 net shares of common stock were issued in early January 2015 after employees surrendered 19,196 shares for which we paid \$87,000 of withholding taxes on their behalf.

F) **Business Segments.** 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 for the three and six months ended June 30, 2015 and 2014 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
United States	\$2,526	\$5,295	\$5,014	\$10,791
Brazil	928	398	1,654	437
Rest of World	1,056	1,074	1,965	2,156
	\$4,510	\$6,767	\$8,633	\$13,384

Revenue by product group for the three and six months ended June 30, 2015 and 2014 was (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Biometrics	\$3,883	\$6,029	\$7,731	\$12,210
Imaging	522	574	696	697
DSL royalties	105	164	206	477
	\$4,510	\$6,767	\$8,633	\$13,384

G) **Recent Accounting Pronouncements.** In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The ASU is the result of a joint project by the FASB and the International Accounting Standards Board (“IASB”) to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards (“IFRS”) that would: remove inconsistencies and weaknesses, provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices across entities, jurisdictions, industries, and capital markets, improve disclosure requirements and resulting financial statements, and simplify the presentation of financial statements. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU is effective for annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. On July 9, 2015, the FASB voted to delay the effective date of the new revenue standard by one year, but to permit entities to choose to adopt the

standard as of the original effective date. We are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

With the exception of the new revenue standard discussed above, there have been no other recently issued accounting pronouncements that are of significance or potential significance to us that we have not adopted as of June 30, 2015.

Income Taxes. Income tax expense was \$0.2 million and \$0.5 million for the three months ended June 30, 2015 and 2014, respectively. Income tax expense was \$0.4 million and \$1.0 million for the six months ended June 30, 2015 and 2014, respectively. Income tax expense in the three and six month periods of 2015 and 2014 was based on the U.S. statutory rate of 34%, increased by state income taxes.

In the six month periods ended June 30, 2015 and 2014, we utilized deferred tax assets to reduce our tax liability payable to the government. A portion of the deferred tax assets we used comprised cumulative deductions for stock options in excess of book expense. Under income tax accounting rules, that portion of tax benefits attributable to such deductions must be recorded as an adjustment to equity versus a reduction of income tax expense. The tax benefits from such stock-based awards were \$0.6 million and \$0.6 million in the six month periods ended June 30, 2015 and 2014, respectively. These tax benefits were recorded as an equity adjustment to additional paid-in capital.

As of June 30, 2015, we had a total of \$0.9 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, 2014 of \$4.0 million and \$0.3 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. The aforementioned \$0.6 million and \$0.6 million equity adjustment to additional paid-in capital in the six month periods ended June 30, 2015 and 2014 were related to these deferred tax assets.

The Internal Revenue Service commenced an examination of our tax return for the year ended December 31, 2012 in September 2014.

D) **Accumulated Other Comprehensive Loss.** The components of accumulated other comprehensive loss and activity were as follows (in thousands):

	December 31, 2014	Increase/ Decrease	Reclassification Adjustments	June 30, 2015
Unrealized losses on available for sale securities	(\$ 87)	(\$ 63)	\$ -	(\$ 150)
Unrealized gains on available for sale securities	43	(10)	12	45
Net unrealized gains (losses) on available for sale securities	(44)	(73)	12	(a) (105)
Income tax benefit (expense) on other comprehensive loss	15	25	(4)	36
Total accumulated other comprehensive loss, net of taxes	(\$ 29)	(\$ 48)	\$ 8	(\$ 69)

(a)

– Classified in other income.

ITEM 2:

**Management's Discussion and Analysis of
Financial Condition and Results of Operations**

Cautionary Statement for Purposes of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995

Some of the information in this Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as "may," "will," "expect," "anticipate," "believe," "estimate," "continue" and similar words. You should read statements that contain these words carefully because they: (1) discuss our future expectations; (2) contain projections of our future operating results or financial condition; or (3) state other "forward-looking" information. However, we may not be able to predict future events accurately. The risk factors listed in our Annual Report on Form 10-K for the year ended December 31, 2014, as well as any cautionary language in this Form 10-Q, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this Form 10-Q could materially and adversely affect our business.

Summary of Operations

We are primarily engaged in the development and sale of biometrics products and services. Our software products are used in government and commercial biometrics systems to identify or authenticate people. Principal government applications of biometrics systems include border control, law enforcement, national defense, secure credentialing, access control, and background checks. Principal commercial applications include: i) user authentication for login and access to mobile devices, computers, networks, and software programs; ii) user authentication for financial transactions and purchases (online and in-person); iii) physical access control to buildings, and iv) screening and background checks of prospective employees and customers. We sell our software and services globally through systems integrators and OEMs, and directly to end user customers. We also derive a minor portion of our revenue from the sale of imaging software to OEMs that incorporate that software into medical imaging products.

Summary of Financial Results

Revenue and net income for the three months ended June 30, 2015 were \$4.5 million and \$0.3 million, respectively. These results compared to revenue of \$6.8 million and net income of \$0.9 million in the three months ended June 30,

2014. Lower revenue and net income in the current quarter were primarily due to:

- i) A decrease in hardware sales from \$2.0 million in the year ago quarter to zero in the current quarter; and
- ii) A decrease in services revenue from \$1.3 million in the year ago quarter to \$0.9 million in the current quarter.

Revenue and net income for the six months ended June 30, 2015 were \$8.6 million and \$0.6 million, respectively. These results compared to revenue of \$13.4 million and net income of \$1.7 million in the six months ended June 30, 2014. Lower revenue and net income in the current six month period were primarily due to:

- i) A decrease in hardware sales from \$4.7 million in the six month period in 2014 to zero in the same six month period in 2015; and
- ii) A decrease in DSL royalties from \$0.5 million in the six month period in 2014 to \$0.2 million in the same six month period in 2015.

These and all other financial results are discussed in more detail in the results of operations section that follows.

Results of Operations

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 end user customers or indirectly through channel partners.

Software license revenue increased 10% from \$2.1 million in the three months ended June 30, 2014 to \$2.3 million in the same three month period in 2015. As a percentage of total revenue, software license revenue increased from 31% in the second quarter of 2014 to 50% in the current year quarter.

Software license revenue increased 6% from \$3.7 million in the six months ended June 30, 2014 to \$3.9 million in the same six month period in 2015. As a percentage of total revenue, software license revenue increased from 28% in the first six months of 2014 to 45% in the corresponding period of 2015.

For the three and six month periods ended June 30, 2015, the dollar increase in software license revenue primarily reflects an increase in software license revenue from two customers that are developing commercial biometric systems. Higher revenue from these commercial customers was partially offset by lower sales of software licenses to channel partners that serve government customers.

As described in the strategy section of our Form 10-K for the year ended December 31, 2014, our market strategy is to continue to focus on our legacy government biometrics markets and expand into new commercial biometrics markets. While we derived a meaningful amount of license and services revenue from commercial customers in the first half of 2015, we are unable to predict future revenue from commercial markets as these are emerging markets for us.

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 11% from \$1.2 million in the three months ended June 30, 2014 to \$1.3 million in the same three month period in 2015. As a percentage of total revenue, software maintenance revenue increased from 17% in the second quarter of 2014 to 28% in the current year quarter.

Software maintenance revenue increased 11% from \$2.2 million in the six months ended June 30, 2014 to \$2.4 million in the same six month period in 2015. As a percentage of total revenue, software maintenance revenue increased from 16% in the first six months of 2014 to 28% in the corresponding period of 2015.

For the three and six month periods ended June 30, 2015, the dollar increase in software maintenance revenue was primarily due to a base of maintenance revenue from contract renewals from prior periods that grows as we sell maintenance contracts with new licenses in current periods.

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 end user 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 decreased 36% from \$1.3 million in the three months ended June 30, 2014 to \$0.9 million in the same three month period in 2015. As a percentage of total revenue, services decreased from 20% in the second quarter of 2014 to 19% in the current year quarter.

Services decreased 12% from \$2.3 million in the six months ended June 30, 2014 to \$2.1 million in the same six month period in 2015. As a percentage of total revenue, services increased from 18% in the first six months of 2014 to 24% in the corresponding period of 2015.

For the three and six month periods ended June 30, 2015, the dollar decrease in services was primarily due to lower revenue from projects with two direct U.S. government customers. The larger of those projects has contributed significantly to quarterly services revenue since its commencement in 2013. This project began to wind down in the second quarter of 2015 and is expected to be completed in the third quarter of 2015. Lower services revenue from these two government projects was partially offset by higher revenue from two projects with customers that are developing biometrics systems for commercial applications. These commercial projects are the same as those mentioned in the software license section above.

Services revenue in future periods may decline compared to comparable periods in 2014 unless we can replace the loss of revenue from the large U.S. government project mentioned in the previous paragraph with services revenue from other government and commercial customers.

Hardware. Hardware revenue consists of sales of biometrics equipment to a single U.S. government customer for whom we developed biometrics 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.

Hardware sales decreased 100% from \$2.0 million in the three months ended June 30, 2014 to zero in the same three month period in 2015. As a percentage of total revenue, hardware sales decreased from 30% in the second quarter of 2014 to 0% in the current year quarter.

Hardware sales decreased 100% from \$4.7 million in the six months ended June 30, 2014 to zero in the same six month period in 2015. As a percentage of total revenue, hardware sales decreased from 35% in the first six months of 2014 to 0% in the corresponding period of 2015.

For the three and six month periods ended June 30, 2015, the dollar decrease in hardware sales was due to the fact that we delivered no hardware to our government customer through June 30, 2015.

In April 2015, we received a \$1.1 million hardware order that we expect to deliver in the third or fourth quarter of 2015. Notwithstanding this order, future orders from this customer may be minimal as we believe it has completed the

bulk of its purchasing. Despite this expectation, we are unable to predict future hardware sales with any degree of certainty because forecasting our customer's demand is difficult. If we are unable to replace the lost gross profit on hardware revenue with sales of other products and services in future periods, our operating results may be adversely affected. It is worth noting that our strategy does not include maintaining or growing biometrics hardware revenue. We agreed to provide hardware products as an accommodation to an important customer.

Royalties. Royalties consist primarily 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 are reported in continuing operations in accordance with ASC 205-20, Reporting Discontinued Operations, because we have continuing ongoing cash flows from this business.

Royalties decreased 36% from \$164,000 in the three months ended June 30, 2014 to \$105,000 in the same three month period in 2015. As a percentage of total revenue, royalties were unchanged at 2% in the second quarters of 2014 and 2015.

Royalties decreased 57% from \$478,000 in the six months ended June 30, 2014 to \$206,000 in the same six month period in 2015. As a percentage of total revenue, royalties decreased from 4% in the first six months of 2014 to 2% in the corresponding period of 2015.

We do not consider DSL royalties to be a key element of our business and we expect that this revenue will continue to decline in future periods.

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

Cost of hardware sales decreased 100% from \$1.4 million in the three months ended June 30, 2014 to zero in the same three month period in 2015. Cost of hardware as a percentage of hardware sales was 69% in the prior year quarter, which means that product gross margins were 31% in the second quarter of 2014.

Cost of hardware sales decreased 100% from \$3.3 million in the six months ended June 30, 2014 to zero in the same six month period in 2015. Cost of hardware as a percentage of hardware sales was 71% in the first six months of 2014, which means that product gross margins were 29% in that period.

For the three and six month periods ended June 30, 2015, the dollar decrease in cost of hardware was because we delivered no hardware products in the current year periods.

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 decreased 8% from \$618,000 in the three months ended June 30, 2014 to \$569,000 in the same three month period in 2015. Cost of services as a percentage of services increased from 46% in the second quarter of 2014 to 67% in the current quarter, which means that gross margins on services decreased from 54% to 33%. The dollar decrease in cost of services was primarily due to lower services revenue. The margin decrease was related to the large project with the U.S. government customer described in services revenue. As the project neared completion, we incurred additional unexpected costs to resolve issues identified during final software testing.

Cost of services increased 3% from slightly less than \$1.1 million in the six months ended June 30, 2014 to slightly more than \$1.1 million in the same six month period in 2015. Cost of services as a percentage of services increased from 46% in the first six months of 2014 to 54% in the corresponding period in 2015, which means that gross margins on services decreased from 54% to 46%. The dollar increase in cost of services and the margin decline in the six months ended June 30, 2015 were also attributable to the issues we experienced in the second quarter of 2015 with one of our U.S. government customers.

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):

	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
	2015	2014	2015	2014
Research and development expense	\$1,439	\$1,400	\$2,874	\$2,679
Cost of services	569	618	1,116	1,082
Total engineering costs	\$2,008	\$2,018	\$3,990	\$3,761

Research and development expense increased 3% from \$1.4 million in the three months ended June 30, 2014 to slightly more than \$1.4 million in the same three month period in 2015. As a percentage of total revenue, research and development expense increased from 21% in the second quarter of 2014 to 32% in the corresponding period of 2015.

Research and development expense increased 7% from \$2.7 million in the six months ended June 30, 2014 to \$2.9 million in the same six month period in 2015. As a percentage of total revenue, research and development expense increased from 20% in the first six months of 2014 to 33% in the corresponding period of 2015.

As the table immediately above indicates, total engineering costs in the three month period ended June 30, 2015 were essentially unchanged from the corresponding period in 2014. Unchanged engineering spending in the current quarter primarily reflects increased spending on engineers due to headcount growth that was fully offset by lower spending on contractors and recruiting fees for new hires.

Total engineering costs in the six month period ended June 30, 2015 were \$0.2 million higher than the corresponding period in 2014. The spending increase in the current six month period primarily reflects increased spending on engineers due to headcount growth that was partially offset by lower spending on contractors and recruiting fees for new hires.

The headcount growth in our engineering organization was designed to provide the resources we require: i) to pursue new product development initiatives; and ii) to staff customer engineering services projects.

As described in the strategy section of our Form 10-K for the year ended December 31, 2014, we intend to offer more complete biometrics solutions by expanding our product portfolio. We believe this will allow us to sell more software and services into biometrics projects. Our preference is to develop such products internally, however to the extent we are unable to do that, we may purchase or license technologies from third parties. Engineering spending in the first half of 2015 is a reflection of this strategy. 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.

Sales and marketing expense increased 8% from \$1.0 million in the three months ended June 30, 2014 to \$1.1 million in the same three month period of 2015. As a percentage of total revenue, sales and marketing expense increased from

14% in the second quarter of 2014 to 24% in the corresponding period of 2015.

Sales and marketing expense increased 11% from \$1.8 million in the six months ended June 30, 2014 to \$2.0 million in the same six month period of 2015. As a percentage of total revenue, sales and marketing expense increased from 14% in the first six months of 2014 to 24% in the corresponding period of 2015.

For the three and six month periods ended June 30, 2015, the dollar increase in selling and marketing expense was primarily due to the addition of two employees in our sales organization over the past year and higher sales commissions to one of our foreign sales agents.

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 was essentially unchanged at \$1.0 million in the three months ended June 30, 2015 and 2014. As a percentage of total revenue, general and administrative expense increased from 14% in the second quarter of 2014 to 21% in the current year quarter. Unchanged general and administrative expense in the current quarter was primarily due to lower stock-based compensation that was offset by higher legal fees and IT costs associated with an upgrade of our accounting systems.

General and administrative expense decreased 2% from \$1.78 million in the six months ended June 30, 2014 to \$1.75 million in the same six month period in 2015. As a percentage of total revenue, general and administrative expense increased from 13% in the first six months of 2014 to 20% in the corresponding period in 2015. The decrease in general and administrative expense in the first six months of 2015 was primarily due to lower stock-based compensation that was offset by higher IT costs associated with an upgrade of our accounting systems.

Other income. We recorded \$12,000 of other income in the six months ended June 30, 2015 and \$59,000 of other expense in the three months ended June 30, 2014. Other income in 2015 represented a realized gain on the sale of a high yield bond. Other expense in 2014 represented realized losses on the sale of two high yield bonds.

Interest income. Interest income decreased 38% from \$52,000 in three months ended June 30, 2014 to \$33,000 in the same three month period in 2015.

Interest income decreased 47% from \$139,000 in the six months ended June 30, 2014 to \$74,000 in the same six month period in 2015.

For the three and six month periods, the dollar decrease in interest income was primarily due to two factors: i) lower levels of high yield bond investments in 2015 as compared to 2014; and ii) lower cash balances as a result of a \$39.9 million dividend payment in July 2014.

Income taxes. Income tax expense was \$0.2 million and \$0.5 million for the three months ended June 30, 2015 and 2014, respectively. Income tax expense was \$0.4 million and \$1.0 million for the six months ended June 30, 2015 and 2014, respectively. Income tax expense in the three and six month periods of 2015 and 2014 was based on the U.S. statutory rate of 34%, increased by state income taxes.

In the six month periods ended June 30, 2015 and 2014, we utilized deferred tax assets to reduce our tax liability payable to the government. A portion of the deferred tax assets we used comprised cumulative deductions for stock options in excess of book expense. Under income tax accounting rules, that portion of tax benefits attributable to such deductions must be recorded as an adjustment to equity versus a reduction of income tax expense. The tax benefits from such stock-based awards were \$0.6 million and \$0.6 million in the six month periods ended June 30, 2015 and 2014, respectively. These tax benefits were recorded as an equity adjustment to additional paid-in capital.

As of June 30, 2015, we had a total of \$0.9 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, 2014 of \$4.0 million and \$0.3 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. The aforementioned \$0.6 million and \$0.6 million equity adjustment to additional paid-in capital in the six month periods ended June 30, 2015 and 2014 were related to these deferred tax assets.

The Internal Revenue Service commenced an examination of our tax return for the year ended December 31, 2012 in September 2014.

Liquidity and Capital Resources

At June 30, 2015, we had cash and cash equivalents of \$44.5 million, which represented an increase of \$0.5 million from December 31, 2014. The increase in cash and cash equivalents was primarily due to the following factors:

Cash used in operations was \$102,000 in the first six months of 2015. This result included a \$554,000 non-cash item for excess tax benefits from stock-based compensation that reduced cash provided by operations.

Cash provided by investing activities of \$141,000 consisted of \$529,000 from sales of investments less \$320,000 used to purchase a technology license and \$68,000 of purchases of property and equipment.

Cash provided by financing activities of \$489,000 consisted of: i) \$554,000 of excess tax benefits from stock-based compensation; and ii) \$22,000 of proceeds from our employee stock purchase plan. Cash provided by these two activities was partially offset by \$87,000 of cash used to pay income taxes for employees who surrendered shares in connection with stock grants.

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 will be sufficient to fund our operations for at least the next twelve months.

Recent Accounting Pronouncements

See Note G to our Consolidated Financial Statements in Item 1.

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 at June 30, 2015 consisted of two elements:

Cash and cash equivalents. As of June 30, 2015, our cash and cash equivalents of \$44.5 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.

Investments. As of June 30, 2015, our investments of \$0.9 million were invested in high yield bonds with two corporate debt issuers, which mature in 2017 and 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 three to four 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 4:

Controls and Procedures

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

PART II. OTHER INFORMATION

ITEM 1:

Legal Proceedings

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

ITEM 1A:

Risk Factors

The risks described in Item 1A, Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2014, could materially and adversely affect our business, financial condition and results of operations. The risk factors discussed in that Form 10-K do not identify all risks that we face because our business operations could also be affected by additional factors that are not presently known to us or that we currently consider to be immaterial to our operations. No material change in the risk factors discussed in that Form 10-K has occurred.

ITEM 4:

Mine Safety Disclosures

Not applicable.

ITEM 6:

Exhibits

(a) Exhibits

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

Exhibit 31.2 Certification of co-Chief Executive Officer and 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.

Exhibit 101* The following financial statements from Aware, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2015, formatted in XBRL (eXtensible Business Reporting Language), as follows: (i) Consolidated Balance Sheets as of June 30, 2015 and December 31, 2014, (ii) Consolidated Statements of Income and Comprehensive Income for the Three and Six Months Ended June 30, 2015 and June 30, 2014, (iii) Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2015 and June 30, 2014, and (iv) Notes to Consolidated Financial Statements.

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

AWARE, INC.

Date: July 28, 2015 By: /s/ Kevin T. Russell
Kevin T. Russell
co-Chief Executive Officer & co-President
General Counsel

Date: July 28, 2015 By: /s/ Richard P. Moberg
Richard P. Moberg
co-Chief Executive Officer & co-President
Chief Financial Officer (Principal Financial and Accounting Officer)