

AWARE INC /MA/  
Form 10-Q  
October 29, 2013

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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, 2013

Commission file number 000-21129

AWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Massachusetts  
(State or Other Jurisdiction of  
Incorporation or Organization)

04-2911026  
(I.R.S. Employer Identification No.)

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

(781) 276-4000  
(Registrant's Telephone Number, Including Area Code)

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 ☒

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Indicate the number of shares outstanding of the issuer's common stock as of October 21, 2013:

| Class                                    | Number of Shares<br>Outstanding |
|------------------------------------------|---------------------------------|
| Common Stock, par value \$0.01 per share | 22,570,794 shares               |

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AWARE, INC.

FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2013

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

|                                                                                                                                                                | September<br>30,<br>2013<br>(unaudited) | December<br>31,<br>2012<br>(audited) |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------|--------------------------------------|
| <b>ASSETS</b>                                                                                                                                                  |                                         |                                      |
| Current assets:                                                                                                                                                |                                         |                                      |
| Cash and cash equivalents                                                                                                                                      | \$75,418                                | \$71,074                             |
| Accounts receivable, net                                                                                                                                       | 2,754                                   | 3,457                                |
| Receivable from patent arrangement                                                                                                                             | -                                       | 1,121                                |
| Deferred tax assets                                                                                                                                            | 916                                     | 817                                  |
| Prepaid expenses and other current assets                                                                                                                      | 1,093                                   | 528                                  |
| Total current assets                                                                                                                                           | 80,181                                  | 76,997                               |
| Property and equipment, net                                                                                                                                    | 5,644                                   | 5,904                                |
| Investments                                                                                                                                                    | 2,962                                   | 2,010                                |
| Intangible assets                                                                                                                                              | 201                                     | -                                    |
| Long term deferred tax assets                                                                                                                                  | 659                                     | 943                                  |
| Total assets                                                                                                                                                   | \$89,647                                | \$85,854                             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                    |                                         |                                      |
| Current liabilities:                                                                                                                                           |                                         |                                      |
| Accounts payable                                                                                                                                               | \$243                                   | \$328                                |
| Accrued expenses                                                                                                                                               | 101                                     | 148                                  |
| Accrued compensation                                                                                                                                           | 589                                     | 817                                  |
| Accrued professional                                                                                                                                           | 156                                     | 142                                  |
| Due to customers                                                                                                                                               | 3,732                                   | -                                    |
| Deferred revenue                                                                                                                                               | 1,529                                   | 2,204                                |
| Total current liabilities                                                                                                                                      | 6,350                                   | 3,639                                |
| Long-term deferred revenue                                                                                                                                     | 40                                      | 319                                  |
| 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 22,570,794 as of September 30, 2013 and 22,509,518 as of December 31, 2012 | 226                                     | 225                                  |

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|                                     |           |           |
|-------------------------------------|-----------|-----------|
| Additional paid-in capital          | 100,917   | 100,561   |
| Accumulated other comprehensive     |           |           |
| loss                                | (57 )     | (50 )     |
| Accumulated deficit                 | (17,829 ) | (18,840 ) |
| Total stockholders' equity          | 83,257    | 81,896    |
| Total liabilities and stockholders' |           |           |
| equity                              | \$89,647  | \$85,854  |

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

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

|                                                              | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                                              | 2013                                | 2012      | 2013                               | 2012      |
| Revenue:                                                     |                                     |           |                                    |           |
| Software licenses                                            | \$ 2,334                            | \$ 3,387  | \$ 7,704                           | \$ 8,070  |
| Software maintenance                                         | 1,023                               | 661       | 3,187                              | 2,471     |
| Services                                                     | 943                                 | 724       | 2,179                              | 2,100     |
| Hardware sales                                               | -                                   | -         | 1,129                              | -         |
| Royalties                                                    | 170                                 | 484       | 737                                | 1,599     |
| Total revenue                                                | 4,470                               | 5,256     | 14,936                             | 14,240    |
| Costs and expenses:                                          |                                     |           |                                    |           |
| Cost of hardware sales                                       | -                                   | -         | 813                                | -         |
| Cost of services                                             | 494                                 | 421       | 1,075                              | 1,138     |
| Research and development                                     | 1,452                               | 1,466     | 4,504                              | 4,431     |
| Selling and marketing                                        | 931                                 | 1,069     | 2,998                              | 3,143     |
| General and administrative                                   | 922                                 | 854       | 2,580                              | 2,915     |
| Exit costs                                                   | 2,832                               | -         | 2,832                              | -         |
| Total costs and expenses;                                    | 6,631                               | 3,810     | 14,802                             | 11,627    |
| Operating income (loss) before patent related income         | (2,161 )                            | 1,446     | 134                                | 2,613     |
| Gain on sale of patent assets                                | -                                   | 15,167    | -                                  | 86,394    |
| Income from patent arrangement;                              | -                                   | -         | 780                                | -         |
| Operating income (loss) after patent related income          | (2,161 )                            | 16,613    | 914                                | 89,007    |
| Other income                                                 | 27                                  | -         | 27                                 | 85        |
| Interest income                                              | 80                                  | 45        | 239                                | 137       |
| Income (loss) from continuing operations before income taxes | (2,054 )                            | 16,658    | 1,180                              | 89,229    |
| Provision for (benefit from) income taxes                    | (901 )                              | 6,578     | 169                                | 23,248    |
| Income (loss) from continuing operations                     | (1,153 )                            | 10,080    | 1,011                              | 65,981    |
| Income from discontinued operations, net of income taxes     | -                                   | 217       | -                                  | 360       |
| Net income (loss)                                            | (\$ 1,153 )                         | \$ 10,297 | \$ 1,011                           | \$ 66,341 |
| Basic net income (loss) per share:                           |                                     |           |                                    |           |

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|                                                                |             |           |          |           |
|----------------------------------------------------------------|-------------|-----------|----------|-----------|
| Basic net income (loss) per share from continuing operations   | (\$ 0.05 )  | \$ 0.45   | \$ 0.04  | \$ 3.05   |
| Basic net income per share from discontinued operations        | 0.00        | 0.01      | 0.00     | 0.02      |
| Basic net income (loss) per share;                             | (\$ 0.05 )  | \$ 0.46   | \$ 0.04  | \$ 3.07   |
| Diluted net income (loss) per share:                           |             |           |          |           |
| Diluted net income (loss) per share from continuing operations | (\$ 0.05 )  | \$ 0.45   | \$ 0.04  | \$ 3.01   |
| Diluted net income per share from discontinued operations      | 0.00        | 0.01      | 0.00     | 0.02      |
| Diluted net income (loss) per share                            | (\$ 0.05 )  | \$ 0.46   | \$ 0.04  | \$ 3.03   |
| Weighted-average shares – basic                                | 22,571      | 22,339    | 22,533   | 21,609    |
| Weighted-average shares - diluted                              | 22,571      | 22,501    | 22,623   | 21,888    |
| Comprehensive income (loss):                                   |             |           |          |           |
| Net income (loss)                                              | (\$ 1,153 ) | \$ 10,297 | \$ 1,011 | \$ 66,341 |
| Other comprehensive income:                                    |             |           |          |           |
| Unrealized gains (losses) on available for sale securities     | (26 )       | (4 )      | (6 )     | 16        |
| Comprehensive income (loss)                                    | (\$ 1,179 ) | \$ 10,293 | \$ 1,005 | \$ 66,357 |

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

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

|                                                                                                | Nine Months Ended<br>September 30, |           |
|------------------------------------------------------------------------------------------------|------------------------------------|-----------|
|                                                                                                | 2013                               | 2012      |
| Cash flows from operating activities:                                                          |                                    |           |
| Net income                                                                                     | \$1,011                            | \$66,341  |
| Adjustments to reconcile net income to net cash<br>provided by (used in) operating activities: |                                    |           |
| Depreciation and amortization                                                                  | 325                                | 343       |
| Stock-based compensation                                                                       | 445                                | 299       |
| Gain on sale of patent assets                                                                  | -                                  | (86,394 ) |
| Amortization of premium (discount) on investments                                              | 13                                 | (24 )     |
| Gain on sale of investments                                                                    | (27 )                              | (85 )     |
| Loss on disposal of property and equipment                                                     | 27                                 | -         |
| Provision for doubtful accounts                                                                | -                                  | 4         |
| Changes in assets and liabilities:                                                             |                                    |           |
| Accounts receivable                                                                            | 703                                | (277 )    |
| Receivable from patent arrangement                                                             | 1,121                              | -         |
| Inventories                                                                                    | -                                  | 538       |
| Prepaid expenses and other current<br>assets                                                   | (565 )                             | (210 )    |
| Deferred tax assets                                                                            | 185                                | -         |
| Accounts payable                                                                               | (85 )                              | (1 )      |
| Accrued expenses, compensation, and professional                                               | (261 )                             | (90 )     |
| Accrued income taxes                                                                           | -                                  | 5,339     |
| Due to customers                                                                               | 3,732                              | -         |
| Deferred revenue                                                                               | (954 )                             | 112       |
| Net cash provided by (used in) operating activities                                            | 5,670                              | (14,105 ) |
| Cash flows from investing activities:                                                          |                                    |           |
| Purchases of property and equipment                                                            | (117 )                             | (90 )     |
| Proceeds from sale of property and equipment                                                   | 24                                 | -         |
| Purchases of investments                                                                       | (2,008 )                           | (1,017 )  |
| Sales of investments                                                                           | 1,064                              | 855       |
| Purchase of intangible assets                                                                  | (201 )                             | -         |
| Proceeds from sale of patent assets, net                                                       | -                                  | 86,394    |
| Net cash provided by (used in) investing activities                                            | (1,238 )                           | 86,142    |
| Cash flows from financing activities:                                                          |                                    |           |
| Proceeds from issuance of common stock                                                         | 46                                 | 5,896     |
| Payment of dividends                                                                           | -                                  | (25,506 ) |
| Excess tax benefits from stock-based compensation                                              | (63 )                              | 15,761    |
| Payments made for taxes of employees who surrendered                                           |                                    |           |

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|                                                |          |   |           |   |
|------------------------------------------------|----------|---|-----------|---|
| shares related to unrestricted stock           | (71      | ) | (174      | ) |
| Net cash used in financing activities          | (88      | ) | (4,023    | ) |
| Increase in cash and cash equivalents          | 4,344    |   | 68,014    |   |
| Cash and cash equivalents, beginning of period | 71,074   |   | 46,577    |   |
| Cash and cash equivalents, end of period       | \$75,418 |   | \$114,591 |   |
| Supplemental disclosure:                       |          |   |           |   |
| Cash paid for income taxes                     | \$535    |   | \$2,388   |   |

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

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

A)Basis of Presentation. The accompanying unaudited consolidated 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, 2012 in conjunction with our 2012 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 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 September 30, 2013, and of operations and cash flows for the interim periods ended September 30, 2013 and 2012.

The results of operations for the interim period ended September 30, 2013 are not necessarily indicative of the results to be expected for the year.

B)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 \$75.4 million and \$71.1 million as of September 30, 2013 and December 31, 2012, respectively. We classified our cash equivalents of \$70.4 million and \$67.1 million as of September 30, 2013 and December 31, 2012, respectively, within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

Our investments, which consist of high yield corporate debt securities, are also classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices. We categorize our investments as available-for-sale securities, and carry them at fair value in our financial statements. We had \$3.0 million and \$2.0 million of available-for-sale investments as of September 30, 2013 and December 31, 2012, respectively.

As of September 30, 2013, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

| Fair Value Measurement at September 30, 2013 Using:           |                                              |                                       |
|---------------------------------------------------------------|----------------------------------------------|---------------------------------------|
| Quoted Prices in<br>Active Markets<br>for<br>Identical Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |

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|                                                            | (Level 1) | (Level 2) | (Level 3) |
|------------------------------------------------------------|-----------|-----------|-----------|
| Corporate debt securities                                  | \$ 2,962  | \$ -      | \$ -      |
| Money market funds (included in cash and cash equivalents) | 70,408    | -         | -         |
| Total                                                      | \$ 73,370 | \$ -      | \$ -      |

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

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

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

|                                                               | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |          |
|---------------------------------------------------------------|-------------------------------------|------------|------------------------------------|----------|
|                                                               | 2013                                | 2012       | 2013                               | 2012     |
| Net income (loss):                                            |                                     |            |                                    |          |
| Income (loss) from continuing operations                      | (\$1,153                            | ) \$10,080 | \$1,011                            | \$65,981 |
| Income from discontinued operations                           | -                                   | 217        | -                                  | 360      |
| Net income (loss)                                             | (\$1,153                            | ) \$10,297 | \$1,011                            | \$66,341 |
| Shares outstanding:                                           |                                     |            |                                    |          |
| Weighted-average common shares outstanding                    | 22,571                              | 22,339     | 22,533                             | 21,609   |
| Additional dilutive common stock equivalents                  | -                                   | 162        | 90                                 | 279      |
| Diluted shares outstanding                                    | 22,571                              | 22,501     | 22,623                             | 21,888   |
| Basic net income (loss) per share:                            |                                     |            |                                    |          |
| Basic net income (loss) per share from continuing operations  | (\$0.05                             | ) \$0.45   | \$0.04                             | \$3.05   |
| Basic net income per share from discontinued operations       | 0.00                                | 0.01       | 0.00                               | 0.02     |
| Basic net income (loss) per share                             | (\$0.05                             | ) \$0.46   | \$0.04                             | \$3.07   |
| Diluted net income (loss) per share:                          |                                     |            |                                    |          |
| Diluted net income(loss) per share from continuing operations | (\$0.05                             | ) \$0.45   | \$0.04                             | \$3.01   |
| Diluted net income per share from discontinued operations     | 0.00                                | 0.01       | 0.00                               | 0.02     |
| Diluted net income (loss) per share                           | (\$0.05                             | ) \$0.46   | \$0.04                             | \$3.03   |

For the three months ended September 30, 2013, common stock equivalents of 111,349 were not included in the per share calculation for diluted EPS, because we had a net loss and the effect of their inclusion would be anti-dilutive.

For the three month periods ended September 30, 2013 and 2012, options to purchase 825,338 and 25,000 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, 2013 and 2012, options to purchase 825,338 and 829,504 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. The following table presents stock-based employee compensation expenses included in our unaudited consolidated statements of comprehensive income (in thousands):

|                                     | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |       |
|-------------------------------------|-------------------------------------|------|------------------------------------|-------|
|                                     | 2013                                | 2012 | 2013                               | 2012  |
| Cost of services                    | \$12                                | \$2  | \$23                               | \$14  |
| Research and development            | 26                                  | 6    | 53                                 | 68    |
| Selling and marketing               | 5                                   | -    | 10                                 | 134   |
| General and administrative          | 174                                 | 13   | 359                                | 70    |
| Income from discontinued operations | -                                   | -    | -                                  | 13    |
| Stock-based compensation expense    | \$217                               | \$21 | \$445                              | \$299 |

**Stock Option Grants.** We grant stock options under our 2001 Nonqualified Stock Plan. We estimate the fair value of stock options using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. 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.

The following summarizes stock-based grants during 2013 and 2012:

**Stock Option Grants –** We did not grant any stock options in the three and nine month periods ended September 30, 2013. We granted stock options for 0 shares and 50,000 shares in the three and nine month periods ended September 30, 2012, respectively.

**Unrestricted Stock Grants –** We granted shares of unrestricted stock in July 2010 and April 2013. The following summarizes those grants and their related impact on results of operations for the three and nine months ended September 30, 2013 and 2012:

**July 2010 Unrestricted Stock Grant.** In July 2010, we granted 575,443 shares of stock to directors, officers and employees. There was no stock-based compensation expense related to this grant in the three and nine month periods ended September 30, 2013. We expensed \$0 and \$189,000 of stock-based compensation expense related to this grant in the three and nine month periods ended September 30, 2012, respectively.

April 2013 Unrestricted Stock Grant. In April 2013, we granted 130,000 shares of unrestricted stock to directors, officers and employees. The shares are to be issued in two equal installments shortly after June 30, 2013 and December 31, 2013, provided each grantee is serving as a director, officer or employee on those dates. We expensed \$208,000 and \$415,000 of stock-based compensation expense related to this grant in the three and nine months ended September 30, 2013, respectively. The unamortized stock-based compensation charge associated with this grant as of September 30, 2013 is \$208,000, which we anticipate will be charged to expense in the fourth quarter of 2013.

E) Business Segments. We organize ourselves into multiple segments reporting to the chief operating decision makers. The following table provides reportable segment financial data for the three and nine month periods ended September 30, 2013 and 2012 (in thousands):

|                                                      | Segments                |                             |           | Total      |
|------------------------------------------------------|-------------------------|-----------------------------|-----------|------------|
|                                                      | Biometrics<br>& Imaging | DSL<br>Service<br>Assurance | Corporate | Company    |
| Three Months Ended September 30, 2013                |                         |                             |           |            |
| Revenue                                              | \$4,144                 | \$156                       | \$170     | \$ 4,470   |
| Operating income (loss) before patent related income | 1,515                   | (3,457 )                    | (219 )    | (2,161 )   |
| Other income                                         |                         |                             | 27        | 27         |
| Interest income                                      |                         |                             | 80        | 80         |
| Loss from continuing operations before taxes         |                         |                             |           | (2,054 )   |
| Benefit from income taxes                            |                         |                             | (901 )    | (901 )     |
| Loss from continuing operations                      |                         |                             |           | (1,153 )   |
| Income from discontinued operations, net of tax      |                         |                             |           | -          |
| Net loss                                             |                         |                             |           | (\$1,153 ) |
| Three Months Ended September 30, 2012                |                         |                             |           |            |
| Revenue                                              | \$4,287                 | \$485                       | \$484     | \$ 5,256   |
| Operating income (loss) before patent related income | 2,111                   | (446 )                      | (219 )    | 1,446      |
| Gain on sale of patent assets                        |                         |                             | 15,167    | 15,167     |
| Interest income                                      |                         |                             | 45        | 45         |
| Income from continuing operations before taxes       |                         |                             |           | 16,658     |
| Provision for income taxes                           |                         |                             | 6,578     | 6,578      |
| Income from continuing operations                    |                         |                             |           | 10,080     |
| Income from discontinued operations, net of tax      |                         |                             |           | 217        |
| Net income                                           |                         |                             |           | \$ 10,297  |
| Nine Months Ended September 30, 2013                 |                         |                             |           |            |
| Revenue                                              | \$12,982                | \$1,217                     | \$737     | \$14,936   |
| Operating income (loss) before patent related income | 4,848                   | (4,266 )                    | (448 )    | 134        |
| Income from patent arrangement                       |                         |                             | 780       | 780        |
| Other income                                         |                         |                             | 27        | 27         |
| Interest income                                      |                         |                             | 239       | 239        |
| Income from continuing operations before taxes       |                         |                             |           | 1,180      |
| Provision for income taxes                           |                         |                             | 169       | 169        |
| Income from continuing operations                    |                         |                             |           | 1,011      |
| Income from discontinued operations, net of tax      |                         |                             |           | -          |
| Net income                                           |                         |                             |           | \$1,011    |
| Nine Months Ended September 30, 2012                 |                         |                             |           |            |
| Revenue                                              | \$10,847                | \$1,794                     | \$1,599   | \$14,240   |

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|                                                      |       |        |   |        |   |          |
|------------------------------------------------------|-------|--------|---|--------|---|----------|
| Operating income (loss) before patent related income | 4,725 | (1,062 | ) | (1,050 | ) | 2,613    |
| Gain on sale of patent assets                        |       |        |   | 86,394 |   | 86,394   |
| Other income                                         |       |        |   | 85     |   | 85       |
| Interest income                                      |       |        |   | 137    |   | 137      |
| Income from continuing operations before taxes       |       |        |   |        |   | 89,229   |
| Provision for income taxes                           |       |        |   | 23,248 |   | 23,248   |
| Income from continuing operations                    |       |        |   |        |   | 65,981   |
| Income from discontinued operations, net of tax      |       |        |   |        |   | 360      |
| Net income                                           |       |        |   |        |   | \$66,341 |

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

|               | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|---------------|-------------------------------------|----------|------------------------------------|-----------|
|               | 2013                                | 2012     | 2013                               | 2012      |
| United States | \$ 2,588                            | \$ 3,350 | \$ 9,944                           | \$ 9,302  |
| Saudi Arabia  | 524                                 | 338      | 613                                | 360       |
| Rest of World | 1,358                               | 1,568    | 4,379                              | 4,578     |
|               | \$ 4,470                            | \$ 5,256 | \$ 14,936                          | \$ 14,240 |

F)Recent Accounting Pronouncements. There are no recently issued accounting pronouncements applicable to the Company that have not been adopted as of September 30, 2013.

G)Gain on Sale of Patent Assets. We recorded a \$15.2 million gain on the sale of patent assets in the three months ended September 30, 2012. This gain relates to a transaction we completed in September 2012 in which we sold a portion of our patent portfolio pertaining to digital subscriber line (“DSL”) technology for \$16.0 million. The proceeds from the sale were reduced by \$0.8 million of transaction costs.

We recorded an \$86.4 million gain on the sale of patent assets in the nine months ended September 30, 2012. This gain includes the \$15.2 million gain described in the previous paragraph and a \$71.2 million gain on the sale of patent assets that occurred in the second quarter of 2012. In June 2012, we completed a transaction to sell patents pertaining to wireless technology for \$75 million. The proceeds from that sale were reduced by \$3.8 million of transaction costs.

H)Income from patent arrangement. We entered into an arrangement with an unaffiliated third party in 2010 under which we assigned patents in return for royalties on proceeds from patent monetization efforts by the third party. We recorded \$0 and \$0.8 million of income from this patent arrangement in the three and nine months ended September 30, 2013, respectively.

I)Income Taxes. Income tax expense for the three ended September 30, 2013 was a tax benefit of \$901,000. Income tax expense for the nine months ended September 30, 2013 was \$169,000. Income tax expense for 2013 was based on the U.S. statutory rate of 34%, increased by state income taxes. Year-to-date tax expense also reflects two items related to 2012, including:

1. a tax benefit of \$95,000 related to the 2012 research tax credit. This credit was extended retroactively back to January 1, 2012, by the American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013; and
2. a tax benefit of \$148,000 related to a reduction in the estimate of the 2012 tax expense recorded in our 2012 financial statements.

As of September 30, 2013, we had a total of \$1.6 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, 2012 of \$5.1 million and \$0.7 million. These credits

were not recorded as tax assets as they relate to excess stock compensation deductions that may not be recorded as tax assets under generally accepted accounting principles until the amounts have been utilized to reduce our tax liability. To the extent that these assets are used to reduce future taxes, the benefit will be recorded as a reduction to additional paid-in capital.

As a result of exit costs related to our DSL service assurance software business, we have revised our estimate of 2013 taxable income. As a result, we do not expect to utilize any of our excess stock compensation benefits to reduce our tax liability in 2013. Accordingly, we have not recorded any tax benefit to additional paid-in capital in 2013. As a separate matter, we reduced the benefit we recorded to additional paid-in capital in 2012 as a result of the reduction of our actual 2012 tax liability. The amount of the reduction to additional paid-in capital in 2013 related to 2012 was \$63,000.

Income tax expense related to continuing operations was \$6.6 million and \$23.2 million for the three and nine months ended September 30, 2012, respectively. Income tax expense in 2012 was driven by an \$86.4 million gain on sale of patent assets. Income tax expense of \$23.2 million for the nine months ended September 30, 2012 consisted of a \$7.5 million current income tax liability plus a \$15.8 million non-cash adjustment related to cumulative deduction for stock options in excess of book expense that was recorded to equity.

J)Discontinued Operations. In January 2012, our Board of Directors approved the shutdown of our DSL service assurance hardware product line which was previously a component of our DSL Service Assurance Segment. We completed the shutdown in 2012 and no longer have any continuing involvement with or cash flows from this product line. The results of our DSL service assurance hardware product line have been included in discontinued operations in the consolidated statements of comprehensive income. Income from discontinued operations attributable to the DSL service assurance hardware product line was (in thousands):

|                                     | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |          |
|-------------------------------------|-------------------------------------|--------|------------------------------------|----------|
|                                     | 2013                                | 2012   | 2013                               | 2012     |
| Revenue                             | \$ -                                | \$ 724 | \$ -                               | \$ 2,809 |
| Expenses                            | -                                   | 364    | -                                  | 2,206    |
| Income before income taxes          | -                                   | 360    | -                                  | 603      |
| Income taxes                        | -                                   | 143    | -                                  | 243      |
| Income from discontinued operations | \$ -                                | \$ 217 | \$ -                               | \$ 360   |

M)DSL Service Assurance Software Exit. In August 2013, our Board of Directors approved the shutdown of our DSL service assurance software product line, which is the remaining component of our DSL Service Assurance Segment. We intend to provide limited support to customers until December 31, 2013 at which point we expect to complete the shutdown. The results of operations for the DSL service assurance software product line have been reported in continuing operations for the three and nine month periods ended September 30, 2013 and 2012. We anticipate the results of operations for this product line will be reported in discontinued operations commencing next quarter.

We estimate our total shutdown costs to date to be approximately \$3.0 million. Such costs comprise: i) \$3.7 million of payments to customers to terminate contracts, which were offset by \$1.2 million of deferred revenue obligations that were relieved as a result of such contract terminations; ii) \$397,000 of severance and employee-related costs; and iii) \$47,000 of asset write-offs. We recorded \$2.8 million of those costs in "Exit costs" in the consolidated statements of comprehensive income for the three months ended September 30, 2013. The remaining \$165,000 of costs represents employee severance and retention bonuses for employees who have been retained to support customers through December 31, 2013. We intend to charge those costs to expense in the three months ended December 31, 2013, if earned by employees.

We may incur additional costs or receive additional income related to the termination of customer contracts, however we are unable to estimate those amounts at this time.

At September 30, 2013, we recorded a liability for exit costs of \$3.8 million. This liability comprises: i) \$3.7 million of payments due to customers for contract terminations; and ii) \$232,000 of severance and employee related costs earned by employees through September 30, 2013, less \$176,000 of payments made to such employees before the end of the quarter.



The following table is a rollforward of our exit costs liability accounts. Customer contract termination costs were included in “Due to customers” and severance and employee-related costs were included in “Accrued compensation” in the consolidated balance sheets. (in thousands):

|                               | <b>Customer<br/>Contract<br/>Termination<br/>Costs</b> | <b>Severance<br/>and<br/>Employee-Related<br/>Costs</b> | <b>Other<br/>Costs</b> | <b>Total</b> |
|-------------------------------|--------------------------------------------------------|---------------------------------------------------------|------------------------|--------------|
| Balance at June 30, 2013      | \$ -                                                   | \$ -                                                    | \$ -                   | \$ -         |
| Amount charged to expense     | 2,553                                                  | 232                                                     | 47                     | 2,832        |
| Deferred revenue offset       | 1,179                                                  | -                                                       | -                      | 1,179        |
| Payments/write-offs           | -                                                      | (176 )                                                  | (47 )                  | (223 )       |
| Balance at September 30, 2013 | \$ 3,732                                               | \$ 56                                                   | \$ -                   | \$ 3,788     |

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, 2012, 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.** Our principal business operations are focused on biometrics and imaging products now that we have begun the process to shut down our Digital Subscriber Line ("DSL") service assurance product line.

Biometrics products consist of software and services used in biometric systems. Biometrics systems are used in applications such as law enforcement, border control, national defense, secure credentialing, access control and background checks. We typically sell our biometrics software and services to: i) systems integrators that incorporate our software products into biometrics systems that they are developing on behalf of their customers; ii) OEMs that incorporate our products into their biometrics hardware and software solutions; and iii) directly to government agencies that are deploying biometrics systems.

Our imaging products consist of software used primarily in medical imaging applications. Our imaging software is primarily sold to OEMs and systems integrators that incorporate our software into their medical and imaging products.

**Other Activities.** In addition to our core biometrics and imaging business, we have been involved with other business activities that have affected our historical financial results and may affect our future financial results. These activities are described below.

- i) Prior to November 2009, we were a supplier of DSL silicon intellectual property to the semiconductor industry. We continue to receive royalties from two principal customers that use our DSL silicon IP in their DSL chipsets although those royalties have been declining rapidly in recent quarters.
- ii) In 2012, we executed on a strategy to monetize a significant portion of our patent portfolio that was unrelated to our biometrics and DSL service assurance product lines. That effort resulted in two significant patent sales in 2012, which affected our consolidated statements of comprehensive income for the three and nine months ended September 30, 2012. There was no such income in the three and nine months ended September 30, 2013.
- iii) We entered into an arrangement with an unaffiliated third party in 2010 under which we assigned certain patents in return for royalties on proceeds from patent monetization efforts by the third party. We recorded \$0.0 million and \$0.8 million of income from this patent arrangement in the three and nine months ended September 30, 2013,

respectively. We did not record any such income in the three and nine months ended September 30, 2012. We are unable to predict how much more income we might receive from this arrangement, if any, because we do not know whether any patent monetization efforts by the third party will be successful.

iv) In January 2012, our Board of Directors approved the shutdown of our DSL service assurance hardware product line which was previously a component of our DSL Service Assurance Segment. We completed the shutdown in 2012 and no longer have any continuing involvement with or cash flows from this product line. The results of our DSL service assurance hardware product line have been reported as discontinued operations. Income from discontinued operations attributable to the DSL service assurance hardware product line was (in thousands):

|                                     | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |          |
|-------------------------------------|-------------------------------------|--------|------------------------------------|----------|
|                                     | 2013                                | 2012   | 2013                               | 2012     |
| Revenue                             | \$ -                                | \$ 724 | \$ -                               | \$ 2,809 |
| Expenses                            | -                                   | 364    | -                                  | 2,206    |
| Income before income taxes          | -                                   | 360    | -                                  | 603      |
| Income taxes                        | -                                   | 143    | -                                  | 243      |
| Income from discontinued operations | \$ -                                | \$ 217 | \$ -                               | \$ 360   |

v) In August 2013, our Board of Directors approved the shutdown of our DSL service assurance software product line, which is the remaining component of our DSL Service Assurance Segment. We intend to provide limited support to customers until December 31, 2013 at which point we expect to complete the shutdown. The results of operations for the DSL service assurance software product line have been reported in continuing operations for the three and nine month periods ended September 30, 2013 and 2012. We anticipate the results of operations for this product line will be reported in discontinued operations commencing next quarter.

We estimate our total shutdown costs to date to be approximately \$3.0 million. Such costs comprise: i) \$3.7 million of payments to customers to terminate contracts, which were offset by \$1.2 million of deferred revenue obligations that were relieved as a result of such contract terminations; ii) \$397,000 of severance and employee-related costs; and iii) \$47,000 of asset write-offs. We recorded \$2.8 million of those costs in "Exit costs" in the consolidated statements of comprehensive income for the three months ended September 30, 2013. The remaining \$165,000 of costs represents employee severance and retention bonuses for employees who have been retained to support customers through December 31, 2013. We intend to charge those costs to expense in the three months ended December 31, 2013, if earned by employees.

We may incur additional costs or receive additional income related to the termination of customer contracts, however we are unable to estimate those amounts at this time.

At September 30, 2013, we recorded a liability for exit costs of \$3.8 million. This liability comprises: i) \$3.7 million of payments due to customers for contract terminations; and ii) \$232,000 of severance and employee related costs earned by employees through September 30, 2013, less \$176,000 of payments made to such employees before the end of the quarter.

## Summary of Financial Results

The net loss from continuing operations for the three months ended September 30, 2013 was \$1.2 million or \$0.05 per diluted share, which compares to net income from continuing operations of \$10.1 million, or \$0.45 per diluted share, for the three months ended September 30, 2012. Net income from continuing operations in the three months ended September 30, 2012 included an after tax gain on the sale of patent assets of \$8.6 million.

Operating loss before patent related income was \$2.2 million for the three months ended September 30, 2013 compared to income of \$1.4 million for the three months ended September 30, 2012. Lower operating income before patent related income in the three month period ended September 30, 2013 compared to the corresponding period in 2012 was primarily due to costs associated with our decision to exit the DSL service assurance business.

Net income from continuing operations for the nine months ended September 30, 2013 was \$1.0 million, or \$0.04 per diluted share, which compares to net income from continuing operations of \$66.0 million, or \$3.01 per diluted share, for the nine months ended September 30, 2012. Net income from continuing operations in the nine months ended September 30, 2012 included an after tax gain on the sale of patent assets of \$63.1 million.

Operating income before patent related income was \$134,000 and \$2.6 million for the nine months ended September 30, 2013 and 2012, respectively. Lower operating income before patent related income in the nine month period ended September 30, 2013 compared to the corresponding period in 2012 was primarily due to costs associated with our decision to exit the DSL service assurance business.

### Results of Operations

**Software Licenses.** Software licenses consist of revenue from the sale of software licenses for biometrics and imaging, and DSL service assurance applications.

Software license revenue decreased 31% from \$3.4 million in the three months ended September 30, 2012 to \$2.3 million in the same three month period in 2013. As a percentage of total revenue, software license revenue decreased from 64% in the third quarter of 2012 to 52% in the current year quarter. The dollar decrease in software license revenue was primarily due to a \$0.8 million decrease in revenue from the sale of biometrics and imaging software and a \$0.3 million decrease in revenue from the sale of DSL service assurance software.

The decrease in biometrics and imaging license sales was primarily due to a large direct sale to a U.S. government in the year ago quarter. A sale of that magnitude did not occur in the current quarter. The decrease in revenue from the sale of DSL service assurance software was primarily due to our decision to shut down this business this quarter.

Software license revenue decreased 5% from \$8.1 million in the nine months ended September 30, 2012 to \$7.7 million in the same nine month period in 2013. As a percentage of total revenue, software license revenue decreased from 57% in the first nine months of 2012 to 52% in the corresponding period in 2013. The dollar decrease in software license revenue was primarily due to a \$0.4 million decrease in revenue from the sale of DSL service assurance software. Revenue from the sale of biometrics and imaging software was essentially unchanged.

For the nine month periods, the decrease in DSL service assurance software license revenue was primarily due to lower license revenue from a telecom supplier that uses our core Dr. DSL® technology in its products as well as our decision to shut down this business.

**Software maintenance.** Software maintenance consists of revenue from the sale of software maintenance contracts for biometrics and imaging, and DSL service assurance software. Software maintenance contracts entitle customers to receive software support and software updates if and when they become available.

Software maintenance revenue increased 55% from \$0.7 million in the three months ended September 30, 2012 to \$1.0 million in the same three month period in 2013. As a percentage of total revenue, software maintenance revenue increased from 13% in the third quarter of 2012 to 23% in the current year quarter. The dollar increase in software maintenance revenue was primarily due to an increase in revenue from biometrics and imaging maintenance contracts. Revenue from DSL service assurance maintenance contracts was essentially unchanged from the third quarter of 2012.

Software maintenance revenue increased 29% from \$2.5 million in the nine months ended September 30, 2012 to \$3.2 million in the same nine month period in 2013. As a percentage of total revenue, software maintenance revenue increased from 17% in the first nine months of 2012 to 21% in the corresponding period in 2013. The dollar increase in software maintenance revenue was primarily due to an increase in revenue from biometrics and imaging maintenance contracts. Revenue from DSL service assurance maintenance contracts was essentially unchanged.

For the three and nine month periods, the increase in revenue from biometrics and imaging maintenance contracts was primarily due to: 1) higher software license sales over the past year which generally include the purchase of software maintenance; and 2) renewals of maintenance contracts sold in prior years.

Services. Services primarily consist of engineering service fees related to: i) our biometrics and imaging product line; and ii) our DSL service assurance software product line. Service revenue in 2012 also included revenue from a legacy DSL silicon customer.

Services increased 30% from \$724,000 in the three months ended September 30, 2012 to \$943,000 in the same three month period in 2013. As a percentage of total revenue, services increased from 14% in the third quarter of 2012 to 21% in the current year quarter. The dollar increase in services revenue was primarily due to a \$272,000 increase in revenue from the sale of biometrics engineering services, which was partially offset by a \$53,000 decrease in revenue from the sale of DSL service assurance services.

For the three month periods, the increase in revenue from biometrics engineering services was primarily due to revenue from three projects with U.S. government customers. The decrease in revenue from DSL service assurance services was primarily due to the cessation of services to a legacy DSL silicon customer at the end of 2012.

Services increased 4% from \$2.1 million in the nine months ended September 30, 2012 to \$2.2 million in the same nine month period in 2013. As a percentage of total revenue, services were unchanged at 15% in the nine month periods ended September 30, 2012 and 2013. The dollar increase in services revenue was primarily due to a \$0.3 million increase in revenue from the sale of biometrics engineering services, which was partially offset by a \$0.2 million decrease in revenue from the sale DSL service assurance services.

For the nine month periods, the increase in revenue from biometrics engineering services was primarily due to two projects with foreign governments in which we partnered with local system integrators. The decrease in revenue from DSL service assurance services was primarily due to the cessation of services to a legacy DSL silicon customer at the end of 2012.

While we are attempting to grow our biometrics services business, we are unable to predict whether services revenue will trend upward or downward in future periods as we continue to develop this business.

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

There were no hardware sales in the three months ended September 30, 2012 and 2013.

Hardware sales increased from \$0 in the nine months ended September 30, 2012 to \$1.1 million in the same nine month period in 2013. As a percentage of total revenue, hardware sales increased from 0% in the first nine months of 2012 to 8% in the corresponding period in 2013. The dollar increase in hardware sales was due to the commencement of shipments in the second quarter of 2013.

We are unable to predict future hardware sales with any degree of certainty because: i) our contract with the government provides pricing, but does not obligate the government to purchase any products until it provides us with purchase orders; and ii) we have no historical experience with which to make revenue projections. Notwithstanding the foregoing, we received an order in September 2013 for \$4.7 million of hardware products. We intend to ship this order over the next several quarters, subject to product availability at our suppliers.

**Royalties.** Royalties consist of royalty payments we receive under legacy DSL silicon contracts. We receive royalties from DSL silicon customers for the right to incorporate our silicon IP in their DSL chipsets.

Royalties decreased 65% from \$484,000 in the three months ended September 30, 2012 to \$170,000 in the same three month period in 2013. As a percentage of total revenue, royalties decreased from 9% in the third quarter of 2012 to 4% in the current year quarter.

Royalties decreased 54% from \$1.6 million in the nine months ended September, 30, 2012 to \$737,000 in the same nine month period in 2013. As a percentage of total revenue, royalties decreased from 11% in the first nine months of 2012 to 5% in the corresponding period in 2013.

For the three and nine month periods, the dollar decrease in royalties was primarily due to lower DSL royalties from both of our principal licensees. Late last year, one of our licensees achieved chipset sales that exceeded certain sales thresholds in our contractual arrangement. The achievement of those sales thresholds triggered reductions in the royalty rate it is required to pay on certain products and eliminated them altogether on other products. Our other licensee also reported lower royalties to us in both the three and nine month periods of 2013.

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

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

Cost of hardware sales was \$0 in the three months ended September 30, 2012 and 2013 as there were no hardware sales during these periods.

Cost of hardware sales increased from \$0 in the nine months ended September 30, 2012 to \$813,000 in the same nine month period in 2013. Cost of hardware sales as a percentage of hardware sales were 72% in the nine months ended September 30, 2013, which means that gross margins on hardware sales were 28%. The dollar increase in cost of hardware sales was due to the commencement of hardware shipments in the second quarter of 2013.

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

Cost of services increased 17% from \$421,000 in the three months ended September 30, 2012 to \$494,000 in the same three month period in 2013. Cost of services as a percentage of services decreased from 58% in the third quarter of 2012 to 52% in the current quarter, which resulted in a corresponding increase in gross margins on services from 42% to 48%.

Cost of services decreased 6% from slightly more than \$1.1 million in the nine months ended September 30, 2012 to slightly less than \$1.1 million in the same nine month period in 2013. Cost of services as a percentage of services decreased from 54% in the first nine months of 2012 to 49% in the same period in 2013, which resulted in a corresponding increase in gross margins on services from 46% to 51%.

For the three and nine month periods, higher gross margins on services were due to a more profitable mix of biometrics services arrangements with government and commercial 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 technology, products and patents related to our various product lines 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<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|----------------------------------|-------------------------------------|---------|------------------------------------|---------|
|                                  | 2013                                | 2012    | 2013                               | 2012    |
| Research and development expense | \$1,452                             | \$1,466 | \$4,504                            | \$4,431 |
| Cost of services                 | 494                                 | 421     | 1,075                              | 1,138   |
| Total engineering costs          | \$1,946                             | \$1,887 | \$5,579                            | \$5,569 |

For the three and nine month periods, total engineering costs were slightly higher than the corresponding periods in the prior year. The increase reflects two sets of offsetting factors. Total engineering costs increased due to higher spending in our biometrics engineering organization as we attempt to grow our biometrics business. Higher biometrics engineering spending was partially offset by lower spending in our DSL service assurance engineering organization and lower spending for a former engineering employee who was involved with patent development and prosecution in 2012.

Research and development expense decreased 1% from \$1.466 million in the three months ended September 30, 2012 to \$1.452 million in the same three month period in 2013. As a percentage of total revenue, research and development expense increased from 28% in the third quarter of 2012 to 32% in the corresponding period of 2013. The insignificant dollar decrease in research and development expense was due to shifting more engineering resources to work on projects that generated services revenue.

Research and development expense increased 2% from \$4.4 million in the nine months ended September 30, 2012 to \$4.5 million in the same nine month period in 2013. As a percentage of total revenue, research and development expense decreased from 31% in the first nine months of 2012 to 30% in the corresponding period of 2013. The dollar increase in research and development expense was due to shifting less engineering resources to work on projects that generated services revenue.

Our research and development activities are focused primarily on developing biometrics and imaging software.

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

Selling and marketing expense decreased 13% from \$1.1 million in the three months ended September 30, 2012 to \$0.9 million in the same three month period in 2013. As a percentage of total revenue, sales and marketing expense increased from 20% in the third quarter of 2012 to 21% in the corresponding period of 2013.

Selling and marketing expense decreased 5% from \$3.1 million in the nine months ended September 30, 2012 to \$3.0 million in the same nine month period in 2013. As a percentage of total revenue, sales and marketing expense decreased from 22% in the first nine months of 2012 to 20% in the corresponding period.

For the three and nine month periods, the dollar decrease in selling and marketing expense reflects two sets of offsetting factors. Expenses decreased due to: i) lower expenses for a former employee who was involved with the effort to monetize patents in 2012; and ii) lower sales expenses in our DSL service assurance sales organization. The

expense decrease associated with these two factors was partially offset by expense growth in our biometrics sales organization. Expense growth in the biometrics sales organization was driven by new sales employees, new foreign sales agents, and higher sales commissions and travel expenses.

**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 increased 8% from \$854,000 in the three months ended September 30, 2012 to \$922,000 in the same three month period in 2013. As a percentage of total revenue, general and administrative expense increased from 16% in the third quarter of 2012 to 20% in the current year quarter. The dollar increase in general and administrative expense was primarily due to higher stock-based compensation costs associated with a stock grant to directors and officers in April 2013, which was partially offset by lower patent prosecution legal fees and audit fees.

General and administrative expense decreased 11% from \$2.9 million in the nine months ended September 30, 2012 to \$2.6 million in the same nine month period in 2013. As a percentage of total revenue, general and administrative expense decreased from 21% in the first nine months of 2012 to 17% in the corresponding period of 2013. The dollar decrease in general and administrative expense was lower primarily due to two sets of offsetting factors. Expenses decreased due to lower: i) patent prosecution legal fees; ii) audit fees; and iii) general corporate legal fees. Such expense reductions were partially offset by stock-based compensation costs associated with a stock grant to directors and officers in April 2013.

**Exit Costs.** Exit costs consist of costs related to the shutdown of our DSL service assurance software business. In August 2013, our Board of Directors approved the shutdown of our DSL service assurance software product line, which is the remaining component of our DSL Service Assurance Segment. We intend to provide limited support to customers until December 31, 2013 at which point we expect to complete the shutdown. The results of operations for the DSL service assurance software product line have been reported in continuing operations for the three and nine month periods ended September 30, 2013 and 2012. We anticipate the results of operations for this product line will be reported in discontinued operations commencing next quarter.

We estimate our total shutdown costs to date to be approximately \$3.0 million. Such costs comprise: i) \$3.7 million of payments to customers to terminate contracts, which were offset by \$1.2 million of deferred revenue obligations that were relieved as a result of such contract terminations; ii) \$397,000 of severance and employee-related costs; and iii) \$47,000 of asset write-offs. We recorded \$2.8 million of those costs in "Exit costs" in the consolidated statements of comprehensive income for the three months ended September 30, 2013. The remaining \$165,000 of costs represents employee severance and retention bonuses for employees who have been retained to support customers through December 31, 2013. We intend to charge those costs to expense in the three months ended December 31, 2013, if earned by employees.

We may incur additional costs or receive additional income related to the termination of customer contracts, however we are unable to estimate those amounts at this time.

At September 30, 2013, we recorded a liability for exit costs of \$3.8 million. This liability comprises: i) \$3.7 million of payments due to customers for contract terminations; and ii) \$232,000 of severance and employee related costs earned by employees through September 30, 2013, less \$176,000 of payments made to such employees before the end of the quarter.

The following table is a rollforward of our exit costs liability accounts. Customer contract termination costs were included in "Due to customers" and severance and employee-related costs were included in "Accrued compensation" in

the consolidated balance sheets. (in thousands):

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|                               | Customer<br>Contract<br><b>Termination<br/>Costs</b> | Severance<br>and<br>Employee-Related<br>Costs | Other<br>Costs | Total    |
|-------------------------------|------------------------------------------------------|-----------------------------------------------|----------------|----------|
| Balance at June 30, 2013      | \$ -                                                 | \$ -                                          | \$ -           | \$ -     |
| Amount charged to expense     | 2,553                                                | 232                                           | 47             | 2,832    |
| Deferred revenue offset       | 1,179                                                | -                                             | -              | 1,179    |
| Payments/write-offs           | -                                                    | (176 )                                        | (47 )          | (223 )   |
| Balance at September 30, 2013 | \$ 3,732                                             | \$ 56                                         | \$ -           | \$ 3,788 |

**Income from Patent Arrangement.** We entered into an arrangement with an unaffiliated third party in 2010 under which we assigned certain patents in return for royalties on proceeds from patent monetization efforts by the third party. We recorded \$0 and \$0.8 million of income from this patent arrangement in the three and nine months ended September 30, 2013, respectively. We did not record any such income in the three and nine months ended September 30, 2012. We are unable to predict how much more income we might receive from this arrangement, if any, because we do not know whether any patent monetization efforts by the third party will be successful.

**Other Income.** Other income consists of realized gains on the disposition of high yield bond investments.

Other income increased from \$0 in the three months ended September 30, 2012 to \$27,000 in the same three month period of 2013.

Other income decreased from \$85,000 in the nine month period ended September 30, 2012 to \$27,000 in the same nine month period of 2013.

For the three and nine month periods, increases or decrease in other income are due to the timing of high yield bond sales by us or bond calls by issuers.

**Interest Income.** Interest income increased 76% from \$45,000 in three months ended September 30, 2012 to \$79,000 in the same three month period in 2013.

Interest income increased 75% from \$137,000 in nine months ended September 30, 2012 to \$240,000 in the same nine month period in 2013

For the three and nine month periods, the dollar increase in interest income was primarily due to: i) interest income from high yield bonds; and ii) higher cash balances as a result of the patent sales in 2012.

**Income Taxes.** Income tax expense for the three ended September 30, 2013 was a tax benefit of \$901,000. Income tax expense for the nine months ended September 30, 2013 was \$169,000. Income tax expense for 2013 was based on the U.S. statutory rate of 34%, increased by state income taxes. Year-to-date tax expense also reflects two items related to 2012, including:

1. a tax benefit of \$95,000 related to the 2012 research tax credit. This credit was extended retroactively back to January 1, 2012, by the American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013; and
2. a tax benefit of \$148,000 related to a reduction in the estimate of the 2012 tax expense recorded in our 2012 financial statements.

As of September 30, 2013, we had a total of \$1.6 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, 2012 of \$5.1 million and \$0.7 million. These credits were not recorded as tax assets as they relate to excess stock compensation deductions that may not be recorded as tax assets under generally accepted accounting principles until the amounts have been utilized to reduce our tax liability. To the extent that these assets are used to reduce future taxes, the benefit will be recorded as a reduction to additional paid-in capital.

As a result of exit costs related to our DSL service assurance software business, we have revised our estimate of 2013 taxable income. As a result, we do not expect to utilize any of our excess stock compensation benefits to reduce our tax liability in 2013. Accordingly, we have not recorded any tax benefit to additional paid-in capital in 2013. As a separate matter, we reduced the benefit we recorded to additional paid-in capital in 2012 as a result of the reduction of our actual 2012 tax liability. The amount of the reduction to additional paid-in capital in 2013 related to 2012 was \$63,000.

Income tax expense related to continuing operations was \$6.6 million and \$23.2 million for the three and nine months ended September 30, 2012, respectively. Income tax expense in 2012 was driven by an \$86.4 million gain on sale of patent assets. Income tax expense of \$23.2 million for the nine months ended September 30, 2012 consisted of a \$7.5 million current income tax liability plus a \$15.8 million non-cash adjustment related to cumulative deduction for stock options in excess of book expense that was recorded to equity.

Income from discontinued operations. Income from discontinued operations reflects operating results from our DSL service assurance hardware product line that we shutdown during 2012.

#### Liquidity and Capital Resources

At September 30, 2013, we had cash and cash equivalents of \$75.4 million, which represented an increase of \$4.3 million from December 31, 2012. The increase in cash was primarily due to \$5.7 million of cash provided by operations. Cash from operations was partially offset by \$1.2 million used in investing activities and \$88,000 used in financing activities.

Cash used in investing activities consisted of: i) \$944,000 of net purchases of high yield bond investments; ii) \$93,000 of net property and equipment purchases; and iii) \$201,000 of purchases of intangible assets.

Cash used in financing activities consisted of: i) \$71,000 of cash used to pay income taxes for employees who surrendered shares in connection with stock grants, and ii) \$63,000 of excess tax benefits from stock-based compensation. Cash used by these activities was partially offset by \$46,000 of proceeds from the exercise of stock options.

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 F 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 September 30, 2013 consisted of two elements:

1. Cash and cash equivalents. As of September 30, 2013, our cash and cash equivalents of \$75.4 million were primarily invested in money market funds. The money market funds were invested in high quality, short term financial instruments. Due to the nature, short duration, and professional management of these funds, we do not expect that a general increase in interest rates would result in any material loss.
2. Investments. As of September 30, 2013, our investments of \$3.0 million were invested in high yield bonds with five corporate debt issuers, which mature in 2015 through 2018. While we are exposed to default risk, the high current yield of these bonds largely mitigates interest rate risk. Therefore, due to the high current yield and the two to five year life of these instruments, we do not believe that a general increase in interest rates would result in any material loss.

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

ITEM 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, 2012, 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, except as set forth below.

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

### 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 September 30, 2013, formatted in XBRL (eXtensible Business Reporting Language), as follows: (i) Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012, (ii) Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2013 and September 30, 2012, (iii) Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 and September 30, 2012, 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.

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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: October 29, 2013

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

Date: October 29, 2013

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