AWARE INC /MA/
Form 10-Q
November 08, 2006

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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, 2006

COMMISSION FILE NUMBER 000-21129

AWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

40 MIDDLESEX TURNPIKE, BEDFORD, MASSACHUSETTS, 01730

(Address of Principal Executive Offices)
(Zip Code)

(781) 276-4000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ___ Accelerated Filer X Non-Accelerated Filer ___

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

Indicate the number of shares outstanding of the issuer's common stock as of November 6, 2006:

CLASS	NUMBER OF SHARES OUTSTANDING
Common Stock, par value $0.01 per share	23,569,937

AWARE, INC.
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2006

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PART I. FINANCIAL INFORMATION
ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS
AWARE, INC.

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(UNAUDITED)

	SEPTEMBER 30, 2006	DECEMBE 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,679	$ 13,0
Short-term investments	22,497	23,6
Accounts receivable, net	5,855	3,7
Inventories	752	
Prepaid expenses and other current assets	748	7
Total current assets	42,531	41,3
Property and equipment, net	7,934	8,0
Investments	2,484	
Other assets, net	254	3
Total assets	$ 53,203	$ 49,7
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 456	$ 6
Accrued expenses	302	1
Accrued compensation	1,150	7
Accrued professional	209	2
Deferred revenue	758	5
Total current liabilities	2,875	2,2
Long-term deferred revenue	330	
Stockholders' equity:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized, none outstanding	-	
Common stock, $.01 par value; 70,000,000 shares authorized; issued and outstanding, 23,569,937 in 2006 and 23,281,575 in 2005	236	2
Additional paid-in capital	81,434	79,0
Accumulated deficit	(31,672)	(31,8
Total stockholders' equity	49,998	47,5
Total liabilities and stockholders' equity	$ 53,203	$ 49,7

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

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDE SEPTEMBER 30,	
	2006	2005	2006	200
Revenue:				
Product sales	$ 1,736	$ 2,417	$ 4,973	$ 4,
Contract revenue	3,990	1,920	9,924	5,
Royalties	956	750	2,710	2,
Total revenue	6,682	5,087	17,607	11,
Costs and expenses:				
Cost of product sales	286	157	615	
Cost of contract revenue	1,363	826	3,759	2,
Research and development	2,726	2,487	8,646	7,
Selling and marketing	784	721	2,518	2,
General and administrative	843	644	2,930	1,
Total costs and expenses	6,002	4,835	18,468	14,
Income/(loss) from operations	680	252	(861)	(2,
Interest income	490	309	1,342	
Income/(loss) before provision for income taxes	1,170	561	481	(1,
Provision for income taxes	330	-	330	
Net income/(loss)	$ 840	$ 561	$ 151	($ 1,
Net income/(loss) per share - basic	$ 0.04	$ 0.02	$ 0.01	($ 0
Net income/(loss) per share - diluted	$ 0.03	$ 0.02	$ 0.01	($ 0
Weighted average shares - basic	23,552	23,116	23,433	23,
Weighted average shares - diluted	24,987	25,168	24,976	23,

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 SEPTEMBER 30,	
	2006	2005
Cash flows from operating activities:		
Net income (loss)	$ 151	($ 1,275)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	491	460
Stock-based compensation	1,694	-
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	(2,106)	(536)
Inventories	(666)	89
Prepaid expenses	17	(239)
Accounts payable	(151)	90
Accrued expenses	567	389
Deferred revenue	551	(10)
Net cash provided by (used in) operating activities	548	(1,032)
Cash flows from investing activities:		
Purchases of property and equipment	(301)	(219)
Other assets	-	(339)
Sales of investments	14,031	20,028
Purchases of investments	(15,316)	(13,388)
Net cash provided by (used in) investing activities	(1,586)	6,082
Cash flows from financing activities:		
Proceeds from issuance of common stock	649	842
Net cash provided by financing activities	649	842
Increase (decrease) in cash and cash equivalents	(389)	5,892
Cash and cash equivalents, beginning of period	13,068	7,482
Cash and cash equivalents, end of period	$ 12,679	$ 13,374

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 balance sheet, statements of operations, and statements of cash flows reflect all adjustments (consisting only of normal recurring items) which are, in the opinion of management, necessary for a fair presentation of financial position at September 30, 2006, and of operations and cash flows for the interim periods ended September 30, 2006 and 2005.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a complete presentation of our financial position, results of operations and cash flows, in conformity with generally accepted accounting principles. We filed audited financial statements which included all information and footnotes necessary for such presentation for the three years ended December 31, 2005 in conjunction with our 2005 Annual Report on Form 10-K.

The results of operations for the interim period ended September 30, 2006 are not necessarily indicative of the results to be expected for the year.

B) INVENTORY

Inventory consists primarily of the following (in thousands):

	SEPTEMBER 30, 2006	DECEMBER 31, 2005
Raw materials	$752	$86

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.

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2006	2005	2006	2005
Net income (loss)	$ 840	$ 561	$ 151	($ 1,275)
Weighted average common shares outstanding .	23,552	23,116	23,433	23,027
Additional dilutive common stock equivalents	1,435	2,052	1,543	-
Diluted shares outstanding	24,987	25,168	24,976	23,027
Net income (loss) per share - basic	$ 0.04	$ 0.02	$ 0.01	($ 0.06)
Net income (loss) per share - diluted	$ 0.03	$ 0.02	$ 0.01	($ 0.06)

For the nine month period ended September 30, 2005, potential common stock equivalents of 1,789,280 were not included in the per share calculation for diluted EPS, because we had net losses and the effect of their inclusion would be anti-dilutive. For the three month periods ended September 30, 2006 and 2005, options to purchase 2,441,742 and 202,167 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive. For the nine month periods ended September 30, 2006 and 2005, options to purchase 2,415,492 and 1,876,167 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

D) STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards 123(R), "Share-Based Payment," ("SFAS 123(R)"), which establishes accounting for equity instruments exchanged for employee services. Under the provisions of SFAS 123(R), stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award). Prior to January 1, 2006, the Company accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB 25") and related interpretations. The Company also followed the disclosure requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The Company elected to adopt the modified prospective transition method as provided by SFAS 123(R) and, accordingly, financial statement amounts for the prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of expensing stock-based compensation.

FIXED STOCK OPTION PLANS - We have three fixed option plans. Under the 1990 Incentive and Nonstatutory Stock Option Plan ("1990 Plan"), we may grant incentive stock options or nonqualified stock options to our employees and directors for up to 2,873,002 shares of common stock. Under the 1996 Stock Option Plan ("1996 Plan"),

we may grant incentive stock options or nonqualified stock options to our employees and directors for up to 6,100,000 shares of common stock. Under the 2001 Nonqualified Stock Plan ("2001 Plan"), we may grant nonqualified stock options or stock awards to our employees and directors for up to 8,000,000 shares of common stock. Under all three plans, options are granted at an exercise price as determined by the Board of Directors and have terms ranging from four to a maximum of ten years. Our options generally vest over three to five years, although we have granted options that are 50% or fully vested on the date of grant. As of September 30, 2006, there were 5,107,363 shares available for grant under the 2001 Plan, and no shares available under the 1990 and 1996 Plans.

During the three (3) months ended June 30, 2006, the Company awarded unrestricted stock to its employees under the 2001 Plan. Half of the award was distributed in the second quarter of 2006 and the remaining shares will be distributed in the fourth quarter of 2006 to eligible employees. In the second quarter of 2006, a total of 31,895 shares were distributed representing $189,000 of stock-based compensation expense.

Employee Stock Purchase Plan - In June 1996, we adopted an Employee Stock Purchase Plan (the "ESPP Plan") under which eligible employees could purchase common stock at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or end of each six-month offering period. On November 29, 2005 we amended the ESPP Plan to provide that eligible employees may purchase common stock at a price equal to 95% of the fair market value of the common stock as of the end of each six-month offering period. Participation in the ESPP Plan is limited to 6% of an employee's compensation, may be terminated at any time by the employee and automatically ends on termination of employment. A total of 350,000 shares of common stock have been reserved for issuance. As of September 30, 2006 there were 138,046 shares available for future issuance under the ESPP Plan. During the three months ended September 30, 2006, no common shares were issued under the ESPP Plan.

The following table presents stock-based employee compensation expenses included in the Company's unaudited condensed consolidated statements of operations (in thousands):

	THREE MONTHS ENDED SEPTEMBER 30, 2006	NINE MONTHS ENDED SEPTEMBER 30, 2006
Cost of product sales	$ 4	$ 12
Cost of contract revenue	13	98
Research and development	241	786
Selling and marketing	88	266
General and administrative	106	532
Stock-based compensation expense	$ 452	$1,694

As a result of adopting SFAS 123(R), the Company's net income for the three and nine months ended September 30, 2006 was lower by $452,000 and

$1,694,000, respectively, than if it had continued to account for stock-based compensation under APB 25. Basic and diluted earnings per share for the three and nine months ended September 30, 2006 was also lower by $0.02 and $0.07, respectively, due to the adoption of SFAS 123(R).

The Company estimates the fair value of stock options using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well

as a variety of significant assumptions. These assumptions used to estimate the fair value of stock options include the expected term, the expected volatility of the Company's stock over the expected term, the risk-free interest rate over the expected term, and the Company's expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company's stock options granted in the three months ended September 30, 2006. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

Assumptions used to determine the fair value of options granted during the three and nine months ended September 30, 2006, using the Black-Scholes valuation model were:

	THREE MONTHS ENDED SEPTEMBER 30, 2006	NINE MONTHS ENDED SEPTEMBER 30, 2006
Expected term(1)	4.75 years	3.25 - 6.25 year
Expected volatility factor(2)	64%	64-67
Risk-free interest rate(3)	4.84%	4.47-4.99
Expected annual dividend yield	--	-

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(1) The expected term for each grant was determined as the midpoint between the vesting date and the end of the contractual term, also known as the "simplified method" for estimating the expected term described by Staff Accounting Bulletin No. 107 ("SAB 107").

(2) The expected volatility for each grant is estimated based on an average of historical volatility for a period equal to the expected term of the stock option.

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

There is no stock-based compensation expense related to the Company's Employee Stock Purchase Plan because it is not considered a compensatory plan. The plan does not have a look-back feature, and has a minimal discount of 5% of the fair market value of the common stock as of the end of each six-month offering period.

Prior to January 1, 2006, the Company accounted for stock-based compensation to employees in accordance with APB 25. The Company also had previously adopted the provisions of SFAS 123, which required disclosure only of stock-based compensation and its impact on net income (loss) and net income (loss) per share. The following table illustrates the effects on net income (loss) and net income (loss) per share for the three and nine months ended September 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee awards (in thousands):

	THREE MONTHS ENDED SEPTEMBER 30, 2005	NINE MONT SEPTEMBER
Net income (loss) as reported	$ 561	$ (
Add: Stock-based employee compensation expense included in net income (loss)		
Less: Total stock-based employee compensation expense determined under the fair value method	(593)	(
Pro forma net loss	($ 32)	($1
Net income (loss) per share:		
Basic and diluted -- as reported	$ 0.02	($
Basic and diluted -- pro-forma	$ 0.00	($

In determining the stock-based compensation expense to be disclosed under SFAS 123, the Company was required to estimate the fair value of stock awards granted to employees using the Black-Scholes valuation model. However, differences between the requirements of SFAS 123(R) and SFAS 123 resulted in a different set of assumptions determined by the Company to be used in its valuation model. Assumptions used to determine the fair value of options granted under SFAS 123 during the three and nine months ended September 30, 2005 were:

	THREE MONTHS ENDED SEPTEMBER 30, 2005	NINE MONTHS ENDED SEPTEMBER 30, 2005
Expected term	5 years	5 years
Volatility	82%	82-87%
Risk-free interest rate	4.04%	3.87-4.04%
Dividend yield	--	--

The Company issues common stock from previously authorized but unissued

shares to satisfy option exercises and purchases under the Company's Employee Stock Purchase Plan.

A summary of the Company's stock option activity for the nine months ended September 30, 2006 is as follows:

	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	WEI AVE REMA CONTR TER YE
Outstanding, December 31, 2005	6,284,606	$ 4.73	
Granted	236,500	5.55	
Exercised	(254,706)	3.01	
Cancelled	(159,087)	6.77	
Outstanding, September 30, 2006	6,107,313	$4.78	
Exercisable at September 30, 2006	5,670,567	$4.71	

All options granted during the nine months ended September 30, 2006 and 2005 were granted with exercise prices equal to the fair market value of the Company's common stock

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on the grant date and had weighted average grant date fair values of $3.02 and $4.22, respectively.

At September 30, 2006, the aggregate intrinsic value of options outstanding and options exercisable was $29,200,000 and $26,695,000, respectively. The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option.

The aggregate intrinsic value of options exercised during the nine months ended September 30, 2006 was $710,000.

The following table summarizes the stock options outstanding at September 30, 2006:

	OPTIONS OUTSTANDING			OPTIONS EXERC
EXERCISE PRICE RANGE	NUMBER	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL TERM (IN YEARS)	NUMBER

$0 to $5	3,628,146	$ 3.18	7.21	3,595,300
$5 to $10	2,390,500	6.10	7.39	1,986,600
$10 to $20	2,417	12.75	0.64	2,417
$20 to $30	16,750	20.38	4.05	16,750
$30 to $40	45,000	33.56	2.71	45,000
$40 to $50	14,500	44.02	3.46	14,500
$50 to $70	10,000	58.06	3.01	10,000
	6,107,313	$ 4.78	7.22	5,670,567

At September 30, 2006, unrecognized compensation expense related to non-vested stock options was $1,117,000, which is expected to be recognized over a weighted average period of 2 years.

E) BUSINESS SEGMENTS

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

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS SEPTEMBER
	2006	2005	2006
North America..................................	$3,396	$3,470	$10,604
Europe...	1,223	1,598	4,892
Rest of World..................................	2,063	19	2,111
	$6,682	$5,087	$17,607

F) RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standards Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in

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Income Taxes." FIN 48 clarifies the accounting for uncertainty in income tax positions taken or expected to be taken in tax returns that effect amounts reported in a company's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 establishes a threshold condition that a tax position must meet for any

part of the benefit of that position to be recognized in the financial statements. FIN 48 also provides guidance concerning derecognition, measurement, classification, interest and penalties and disclosure of tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects of FIN 48.

In May 2005, the FASB issued FASB Statement No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements" ("FAS 154"). FAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. FAS 154 also provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The provisions of this Statement are effective for accounting changes and corrections of errors made in fiscal periods beginning after December 15, 2005. The adoption of the provisions of FAS 154 is not expected to have a material impact on the Company's financial position or results of operations.

In September 2006 the FASB issued Statement No. 157, FAIR VALUE MEASUREMENTS. The Statement provides guidance for using fair value to measure assets and liabilities. This Statement references fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The Statement applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The Statement does not expand the use of fair value in any new circumstances. It is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of SFAS No. 157 is not expected to have a material impact on our financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission, or SEC, Staff issued Staff Accounting Bulletin No. 108 (SAB 108) addressing how the effects of prior-year uncorrected financial statement misstatements should be considered in current-year financial statements. SAB 108 requires registrants to quantify misstatements using both balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relative quantitative and qualitative factors. SAB 108 does not change the SEC staff's previous guidance in Staff Accounting Bulletin No. 99 on evaluating the materiality of misstatements.

SAB 108 addresses the mechanics of correcting misstatements that include the effects from prior years. Additionally, SAB 108 requires registrants to apply the new guidance for the first time that it identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006 by correcting those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. We do not anticipate the adoption of SAB 108 to have a material effect on our financial position, results of operations or cash flows.

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

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

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

RESULTS OF OPERATIONS

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

Product sales decreased 28% from $2.4 million in the third quarter of 2005 to $1.7 million in the current year quarter. As a percentage of total revenue, product sales decreased from 48% in the third quarter of 2005 to 26% in the current year quarter. For the nine months ended September 30, product sales increased 19% from $4.2 million in 2005 to $5.0 million in 2006. As a percentage of total revenue, product sales decreased from 35% in the first nine months of 2005 to 28% in the corresponding period of 2006.

For the three month period, the dollar decrease was due to a $0.9 million decrease in revenue from the sale of software products, offset by a $0.2 million increase from the sale of hardware products. For the nine month period, the dollar increase was due to a $0.3 million increase in revenue from the sale of software products and a $0.5 million increase from the sale of hardware products.

CONTRACT REVENUE. Contract revenue consists of patent, license and engineering service fees that we receive under customer agreements relating to Aware's patents, Aware's DSL technology and Aware's DSL test and diagnostics technology.

Contract revenue increased 108% from $1.9 million in the third quarter of 2005 to $4.0 million in the current year quarter. As a percentage of total revenue, contract revenue increased from 38% in the third quarter of 2005 to 60% in the current year quarter. The increase of $2.1 million was primarily due to patent and license fees that we received under agreements with our customers including a patent license agreement with a new customer.

For the nine months ended September 30, contract revenue increased 96% from $5.1 million in 2005 to $9.9 million in the current year. As a percentage of total revenue, contract revenue increased from 42% in the first nine months of 2005 to 56% in the corresponding period of 2006. The dollar increase was due to $2.5 million recognized from the transfer of certain technology licenses as a result of the acquisition of a customer's business, plus an increase of $2.3 million due to patent and license fees that we received under agreements with our customers, including a patent licensing agreement with a new customer.

While we believe that the transition to ADSL2plus and VDSL2 technology increases the value proposition of our technology, some existing and prospective DSL chipset licensees have continued to be reluctant to begin new development projects given a difficult and uncertain environment in the semiconductor and telecommunications industries, and intense ADSL chipset competition and falling chipset prices. During the last several years, customers and potential customers cautiously evaluated new chipset projects or delayed or cancelled projects in the face of such conditions.

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

Royalties increased 27% from $0.8 million in the third quarter of 2005 to $1.0 million in the current year quarter. As a percentage of total revenue, royalties decreased from 15% in the third quarter of 2005 to 14% in the current year quarter. The dollar increase in royalty revenues was a result of increased chipset sales by our customers. For the nine months ended September 30, royalties decreased 2% from $2.8 million in 2005 to $2.7 million in the current year. As a percentage of total revenue, royalties decreased from 23% in the first nine months of 2005 to 15% in the corresponding period of 2006. The dollar decrease in royalty revenues was due to lower royalties from DSL chipset customers. The decrease in royalty as a percentage of total revenue is due to the increase in both product sales and contract revenue.

Our royalty revenue comes predominantly from ADSL chipset sales by Ikanos Communications, Inc. ("Ikanos"), and Infineon Technologies AG ("Infineon"). On February 17, 2006, Analog Devices, Inc. ("ADI") sold its ADSL business relating to Aware technology to Ikanos and Ikanos has replaced ADI as an Aware licensee. Despite steady growth of worldwide ADSL subscribers over the last several years, the availability of ADSL chipsets from a number of suppliers and intense competition among those suppliers has caused chipset prices to steadily decline. We are uncertain how the transition to ADSL2plus and VDSL2 will impact our customers in the near term, how quickly sales of our customers' chipsets will increase and whether such increases will continue to contribute meaningful royalties to us.

COST OF PRODUCT SALES. Since the cost of software product sales is minimal, cost of product sales consists primarily of the cost of hardware product sales. Cost of product sales increased 82% from $157,000 in the third quarter of 2005 to $286,000 in the current year quarter. As a percentage of product sales, cost of product sales increased from 7% in the third quarter of 2005 to 16% in the current year quarter. For the nine months ended September 30, cost of product sales increased 120% from $279,000 in 2005 to $615,000 in 2006. As a percentage of product sales, cost of product sales increased from 7% in the first nine months of 2005 to 12% in the corresponding period of 2006.

The percentage and dollar increases were primarily due to an increase in hardware manufacturing and period costs related to new hardware products. In addition, $4,000 and $12,000 of the

current quarter and nine month period increases, respectively, were from stock-based compensation expense. The resulting decrease in product margin was primarily due to a larger proportion of new hardware sales in the product sales revenue mix.

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

Cost of contract revenue increased 65% from $0.8 million in the third quarter of 2005 to $1.4 million in the current year quarter. As a percentage of contract revenue, cost of contract revenue decreased from 43% in the third quarter of 2005 to 34% in the current year quarter. For the nine months ended September 30, cost of contract revenue increased 58% from $2.4 million in 2005 to $3.8 million in 2006. As a percentage of contract revenue, cost of contract revenue decreased from 47% in the first nine months of 2005 to 38% in the corresponding period of 2006.

The dollar increase in cost of contract revenue was primarily due to more customer projects in the three month and nine month periods of 2006 as compared with 2005. Our cost of contract revenue is based on the level of effort we expend on customer projects. Since the number of customer projects increased, the cost of contract revenue increased as well. In addition, $13,000 and $98,000 of the current quarter and nine month period increases, respectively, were from stock-based compensation expense.

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

Research and development expense increased 10% from $2.5 million in the third quarter of 2005 to $2.7 million in the current year quarter. As a percentage of total revenue, research and development expense decreased from 49% in the third quarter of 2005 to 41% in the current year quarter. For the nine months ended September 30, research and development expense increased 17% from $7.4 million in 2005 to $8.6 million in 2006. As a percentage of total revenue, research and development expense decreased from 62% in the first nine months of 2005 to 48% in the corresponding period of 2006.

For the three month and nine month periods, the dollar increase was $241,000 and $786,000, respectively, of stock-based compensation expense, increased compensation and fringe benefit cost, and increased patent legal fees. These increases were partially offset by a shift of engineers to customer projects, where spending is classified as cost of contract revenue. This shift occurred because we had more customer projects in 2006 than in 2005.

Our research and development spending was principally focused on improving our ADSL, ADSL2 and ADSL2plus StratiPHY2+(TM) technology and chips, developing and improving our VDSL2 StratiPHY3 technology and chips, developing analog front-end

technology for DSL solutions, developing test and diagnostics hardware and software and developing imaging and biometrics software.

SELLING AND MARKETING EXPENSE. Selling and marketing expense consists primarily of compensation costs for sales and marketing personnel, travel, advertising and promotion,

recruiting, and facilities expense. Sales and marketing expense of $0.8 million in the third quarter of 2006 increased 9% compared to $0.7 million in the corresponding quarter of 2005. As a percentage of total revenue, sales and marketing expense decreased from 14% in the third quarter of 2005 to 12% in the current year quarter due to higher revenues. For the three month period, the dollar increase was mainly attributable to stock-based compensation expense of $88,000.

For the nine months ended September 30, selling and marketing expense of $2.5 million increased 22% from $2.1 million in 2005. As a percentage of total revenue, selling and marketing expense decreased from 17% in the first nine months of 2005 to 14% in the corresponding period of 2006. For the nine month period, the dollar increase was mainly attributable to stock-based compensation expense of $266,000 and other compensation expenses of $130,000.

GENERAL AND ADMINISTRATIVE EXPENSE. General and administrative expense consists primarily of compensation costs for administrative personnel, facility costs, bad debt, audit, legal, stock exchange and insurance expenses. General and administrative expenses increased 31% from $0.6 million in the third quarter of 2005 to $0.8 million in the current year quarter. As a percentage of total revenue, general and administrative expense decreased slightly and was approximately 13% in both the third quarter of 2005 and in the current year quarter. For the three month period, the dollar increase was mainly attributable to stock-based compensation expense of $106,000 and other compensation expenses of $54,000.

For the nine months ended September 30, general and administrative expense increased 51% from $1.9 million in 2005 to $2.9 million in 2006. As a percentage of total revenue, general and administrative expense remained relatively flat at approximately 16% in the first nine months of 2005 and 2006. For the nine month period, the dollar increase was mainly attributable to stock-based compensation expense of $532,000, other compensation expenses of $266,000 and professional fees of $53,000.

INTEREST INCOME. Interest income increased 59% from $309,000 in the third quarter of 2005 to $490,000 in the current year quarter. For the nine months ended September 30, interest income increased 68% from $798,000 in 2005 to $1,342,000 in 2006. For the three and nine month periods, the dollar increase was due to higher interest rates earned on our cash and investment balances.

INCOME TAXES. We made no provision for income taxes in the first nine months of 2005 and 2006 due to net losses incurred and the uncertainty of the timing of profitability in future periods, except for taxes paid in non-U.S. jurisdictions that assess a source withholding tax. In 2002, we determined that due to our continuing operating losses as well as the uncertainty of the timing of profitability in future periods, we should fully reserve our deferred tax assets. As of September 30, 2006, our deferred tax assets continue to be fully reserved. We will continue to evaluate, on a quarterly basis, the positive and negative evidence affecting the realizability of our deferred tax assets.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2006, we had cash, cash equivalents, and short and long-term investments of $37.7 million, which represents an increase of $0.9 million from December 31, 2005. The increase was primarily due to $0.6 million of cash provided by operations and $0.6 million of

proceeds from the exercise of employee stock options. These increases were partially offset by capital expenditures of $0.3 million.

Cash provided by operations in the first nine months of 2006 was from the net income of $0.2 million adjusted for non-cash items related to depreciation and amortization of $0.5 million, stock-based compensation expense of $1.7 million and working capital requirements of $1.8 million. Capital spending was primarily related to the purchase of computer hardware and software, and laboratory equipment used principally in engineering activities.

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

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

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standards Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." FIN 48 clarifies the accounting for uncertainty in income tax positions taken or expected to be taken in tax returns that effect amounts reported in a company's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 establishes a threshold condition that a tax position must meet for any part of the benefit of that position to be recognized in the financial statements. FIN 48 also provides guidance concerning derecognition, measurement, classification, interest and penalties and disclosure of tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects of FIN 48.

In May 2005, the FASB issued FASB Statement No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements" ("FAS 154"). FAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. FAS 154 also provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The provisions of this Statement are effective for accounting changes and corrections of errors made in fiscal periods beginning after December 15, 2005. The adoption of the provisions of FAS 154 is not expected to have a material impact on the Company's financial

position or results of operations.

In September 2006 the FASB issued Statement No. 157, FAIR VALUE MEASUREMENTS. The Statement provides guidance for using fair value to measure assets and liabilities. This Statement references fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The Statement applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The Statement does not expand the use of fair value in any new circumstances. It is effective for financial statements issued for fiscal years

beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of SFAS No. 157 is not expected to have a material impact on our financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission, or SEC, Staff issued Staff Accounting Bulletin No. 108 (SAB 108) addressing how the effects of prior-year uncorrected financial statement misstatements should be considered in current-year financial statements. SAB 108 requires registrants to quantify misstatements using both balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relative quantitative and qualitative factors. SAB 108 does not change the SEC staff's previous guidance in Staff Accounting Bulletin No. 99 on evaluating the materiality of misstatements.

SAB 108 addresses the mechanics of correcting misstatements that include the effects from prior years. Additionally, SAB 108 requires registrants to apply the new guidance for the first time that it identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006 by correcting those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. We do not anticipate the adoption of SAB 108 to have a material effect on our financial position, results of operations or cash flows.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

We do not use derivative financial instruments for speculative or trading purposes. As of September 30, 2006, we had $35.2 million in cash, cash equivalents and short-term investments that matured in twelve months or less. Due to the short duration of these financial instruments, we do not expect that

an increase in interest rates would result in any material loss to our investment portfolio.

As of September 30, 2006, we had invested $2.5 million in long-term investments that matured in one to three years. These long-term securities are invested in high quality U.S. government securities. Despite the high quality of these securities, they may be subject to interest rate risk. This means that if interest rates increase, the principal amount of our investment would probably decline. A large increase in interest rates may cause a material loss to our long-term investments. The following table (dollars in thousands) presents hypothetical changes in the fair value of our long-term investments at September 30, 2006. The modeling technique measures the change in fair value arising from selected potential changes in interest rates. Movements in interest rates of plus or minus 50 basis points (BP) and 100 BP reflect immediate hypothetical shifts in the fair value of these investments.

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	VALUATION OF SECURITIES GIVEN AN INTEREST RATE DECREASE OF		NO CHANGE IN INTEREST RATES	VALUATION GIVER AN I INC
Type of security	(100BP)	(50 BP)		100 BP
Long-term investments with maturities of one to three years...	$2,519	$2,501	$2,484	$2,448

ITEM 4:
CONTROLS AND PROCEDURES

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

PART II. OTHER INFORMATION

ITEM 1:
LEGAL PROCEEDINGS

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

ITEM 1A:
RISK FACTORS

RISK FACTORS

OUR QUARTERLY RESULTS ARE UNPREDICTABLE AND MAY FLUCTUATE SIGNIFICANTLY

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

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

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

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

- market acceptance of broadband technologies we supply by semiconductor or equipment companies;
- the extent and timing of new license transactions with semiconductor companies;
- changes in our and our licensees' development schedules and levels of expenditure on research and development;
- the loss of a strategic relationship or termination of a project by a licensee;
- equipment companies' acceptance of integrated circuits produced by our licensees;
- the loss by a licensee of a strategic relationship with an equipment company customer;
- announcements or introductions of new technologies or products by us or our competitors;
- delays or problems in the introduction or performance of enhancements or of future generations of our technology;
- failures or problems in our hardware or software products;
- delays in the adoption of new industry standards or changes in market perception of the value of new or existing standards;
- competitive pressures resulting in lower contract revenues or

royalty rates;

- competitive pressures resulting in lower software or hardware product revenues;
- personnel changes, particularly those involving engineering and technical personnel;
- costs associated with protecting our intellectual property;
- the potential that licensees could fail to make payments under their current contracts;
- ADSL market-related issues, including lower ADSL chipset unit demand brought on by excess channel inventory and lower average selling prices for ADSL chipsets as a result of market surpluses;
- VDSL market-related issues, including lower VDSL chipset unit demand brought on by excess channel inventory and lower average selling prices for VDSL chipsets as a result of market surpluses;
- regulatory developments; and
- general economic trends and other factors.

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

WE EXPERIENCED NET LOSSES

We had a net annual loss during 2001, 2002, 2003, 2004 and 2005, but have net income for the first nine months of 2006. We may experience losses in the future if:

- the semiconductor and telecommunications markets do not improve;
- our existing customers do not increase their revenues from sales of chipsets with our technology;
- new or existing customers do not choose to license our intellectual property for new chipset products; or
- new or existing customers do not choose to use our software or hardware products.

WE HAVE A UNIQUE BUSINESS MODEL

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

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

- we must typically undergo a lengthy and expensive process of building a relationship with a potential licensee before there is any assurance of a license agreement with such party;
- we must persuade semiconductor and equipment manufacturers with significant resources to rely on us for critical technology on an ongoing basis rather than trying to develop similar

technology internally;
- we must persuade potential licensees to bear development costs associated with our technology applications and to make the necessary investment to successfully manufacture chipsets and products using our technology; and
- we must successfully transfer technical know-how to licensees.

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

Our business could be seriously harmed if:

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

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

The royalties we receive are influenced by many of the risks faced by the ADSL market in general, including reduced average selling prices ("ASPs") for ADSL chipsets during periods of surplus. In 2000, 2001, and 2002, the ADSL industry had experienced an oversupply of ADSL

chipsets and central office equipment. Excessive inventory levels led to soft chipset demand, which in turn led to declining ASPs. ASPs have also been under pressure because of intense competition in the ADSL chipset marketplace. As a result of the soft demand and declining ASPs for ADSL chipsets, our royalty revenue has decreased substantially from the levels we achieved in 2000. Price decreases for ADSL or VDSL chipsets, and the corresponding decreases in per unit royalties received by us, can be sudden and dramatic. Pricing pressures may continue during the fourth quarter of 2006 and beyond. Our royalty revenue may decline over the long term.

WE DEPEND SUBSTANTIALLY UPON A LIMITED NUMBER OF LICENSEES

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

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

In 2003, 2004 and 2005, we derived 27%, 28% and 20%, respectively, of our total

revenue from ADI and 20%, 28%, and 30% respectively, of our total revenue from Infineon. ADI and Infineon have developed many generations of ADSL chipsets based upon our technology. On February 17, 2006 ADI sold its ADSL business relating to Aware technology to Ikanos Communications, Inc. ("Ikanos") and Ikanos replaced ADI as an Aware licensee.

Our royalty revenue in the near term is highly dependent upon the respective market share and pricing of Ikanos' and Infineon's ADSL chipsets. The ADSL market has experienced significant price erosion, which has adversely affected ADSL chipset revenues, which in turn has adversely affected our royalty revenue. To the extent that Ikanos or Infineon lose market share or are unable to gain market share, or experience further price erosion in their DSL chipsets, our royalty revenue could decline.

OUR SUCCESS REQUIRES ACCEPTANCE OF OUR TECHNOLOGY BY EQUIPMENT COMPANIES

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

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

- competition from other businesses in the same industry;

- market acceptance of its products;
- its engineering, sales and marketing, and management capabilities;
- technical challenges of developing its products unrelated to our technology; and
- its financial and other resources.

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

OUR SUCCESS REQUIRES TELEPHONE COMPANIES TO INSTALL DSL SERVICE IN VOLUME

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

- the desire of telephone companies to install ADSL or VDSL service, which is dependent on the development of a viable business model for ADSL or VDSL service, including the capability to market, sell, install and maintain the service;

- the pricing of ADSL or VDSL services by telephone companies;
- the success of internet protocol TV ("IPTV") and video over DSL as viable consumer service offerings;
- the transition by telephone companies to new ADSL technologies, such as ADSL2, ADSL2plus and VDSL2;
- the quality of telephone companies' networks;
- deployment by phone companies of fiber-to-the home or broadband wireless services;
- government regulations; and
- the willingness of residential telephone customers to demand DSL service in the face of competitive service offerings, such as cable modems, fiber-based service or broadband wireless access.

If telephone companies do not install DSL service in significant volumes, or if telephone companies install broadband service based on other technology such as cable or fiber-to-the-home, our business will be seriously harmed.

OUR INTELLECTUAL PROPERTY IS SUBJECT TO LIMITED PROTECTION

Because we are a technology provider, our ability to protect our intellectual property and to operate without infringing the intellectual property rights of others is critical to our success. We regard our technology as proprietary, and we have a number of patents and pending patent applications. We also rely on a combination of trade secrets, copyright and trademark law and non-disclosure agreements to protect our unpatented intellectual property. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our technology without authorization.

As part of our licensing arrangements, we typically work closely with our semiconductor and equipment manufacturer licensees, many of whom are also our potential competitors, and provide them with proprietary know-how necessary for their development of customized chipsets based on our ADSL technology. Although our license agreements contain non-disclosure provisions and other terms protecting our proprietary know-how and technology rights, it is possible that, despite these precautions, some of our licensees might obtain from us proprietary information that they could use to compete with us in the marketplace. Although we intend to defend our

intellectual property as necessary, the steps we have taken may be inadequate to prevent misappropriation.

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

Our technology, software or products may infringe the intellectual property rights of others. A large and increasing number of participants in the telecommunications and compression industries have applied for or obtained patents. Some of these patent holders have demonstrated a readiness to commence litigation based on allegations of patent and other intellectual property infringement. Third parties may assert patent, copyright and other intellectual property rights to technologies that are important to our business. In the past,

we have received claims from other companies that our technology infringes their patent rights. Intellectual property rights can be uncertain and can involve complex legal and factual questions. We may infringe the proprietary rights of others, which could result in significant liability for us. If we were found to have infringed any third party's patents, we could be subject to substantial damages and an injunction preventing us from conducting our business.

OUR BUSINESS IS SUBJECT TO RAPID TECHNOLOGICAL CHANGE

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

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

One element of our business strategy is to assume the risks of technology development failure while reducing such risks for our licensees. In the past, we have spent significant amounts on development projects that did not produce any marketable technologies or products, and we cannot assure you that it will not occur again.

WE FACE INTENSE COMPETITION FROM A WIDE RANGE OF COMPETITORS

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

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

anticipate intense competition from suppliers of intellectual property for ADSL and VDSL.

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

ADSL and VDSL services offered over copper telephone networks also compete with alternative broadband transmission technologies that use the telephone network as well as other network architectures. Alternative technologies for the telephone network include several types of symmetric high speed DSL, including HDSL, SDSL and G.SHDSL. Alternative technologies that use other network architectures to provide high-speed data service include cable modems using cable networks, wireless solutions using wireless networks, and optical solutions using fiber optics technology. These alternative broadband transmission technologies may be more successful than ADSL or VDSL and we may not be able to participate in the markets involving these alternative technologies.

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

BIOMETRICS BUSINESS RISKS

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

- market acceptance of our biometric technologies and products;
- changes in contracting practices of government or law enforcement agencies;
- the failure of the biometrics market to experience continued growth;
- announcements or introductions of new technologies or products or our competitors;

- delays or problems in the introduction or performance of enhancements or of future generations of our technology;
- failures or problems in our biometric software products;
- delays in the adoption of new industry biometric standards or changes in market perception of the value of new or existing standards;
- growth of proprietary biometric systems which do not conform to industry standards;
- competitive pressures resulting in lower software product revenues;
- personnel changes, particularly those involving engineering, technical and sales and marketing personnel;
- costs associated with protecting our intellectual property;
- litigation by third parties for alleged infringement of their

proprietary rights;
- the potential that licensees could fail to make payments under their current contracts;
- regulatory developments; and
- general economic trends and other factors.

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

We prepare our financial statements in accordance with generally accepted accounting principles and certain critical accounting polices that are relevant to our business. The application of these principles and policies requires us to make significant judgments and estimates. In the event that judgments and estimates we make are incorrect, we may have to change them, which could materially affect our financial position and results of operations. Moreover, accounting standards have been subject to rapid change and evolving interpretations by accounting standards setting organizations over the past few years. The implementation of new standards requires us to interpret and apply them appropriately. If our current interpretations or applications are later found to be incorrect, our financial position and results of operations could be materially affected.

OUR STOCK PRICE MAY BE EXTREMELY VOLATILE

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

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

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

OUR BUSINESS MAY BE AFFECTED BY GOVERNMENT REGULATIONS

The extensive regulation of the telecommunications industry by federal, state and foreign regulatory agencies, including the Federal Communications Commission, and various state public utility and service commissions, could

affect us through the effects of such regulation on our licensees and their customers. In addition, our business may also be affected by the imposition of certain tariffs, duties and other import restrictions on components that our customers obtain from non-domestic suppliers or by the imposition of export restrictions on products sold internationally and incorporating our technology. Changes in current or future laws or regulations, in the United States or elsewhere, could seriously harm our business.

ITEM 6:
EXHIBITS

(A) EXHIBITS

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

SIGNATURES

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

AWARE, INC.

Date: November 8, 2006

By: /s/ Michael A. Tzannes
Michael A. Tzannes, Chief Executive Officer

Date: November 8, 2006

By: /s/ Keith E. Farris
Keith E. Farris, Chief Financial Officer (Principal Financial and Accounting Officer)