

AWARE INC /MA/
Form 10-Q
October 27, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarter ended September 30, 2015

Commission file number 000-21129

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

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

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

(781) 276-4000

(Registrant's Telephone Number, Including Area Code)

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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

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

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

Indicate the number of shares outstanding of the issuer's common stock as of October 23, 2015:

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

AWARE, INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2015

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

	September 30, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 46,421	\$ 43,985
Accounts receivable, net	2,409	3,619
Inventories	616	2
Deferred tax assets	168	168
Prepaid expenses and other current assets	841	401
Total current assets	50,455	48,175
Property and equipment, net	5,078	5,289
Investments	858	1,428
Long term deferred tax assets	749	804
Other assets	370	197
Total assets	\$ 57,510	\$ 55,893
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 297	\$ 258
Accrued expenses	764	820
Deferred revenue	2,333	2,352
Total current liabilities	3,394	3,430
Long-term deferred revenue	150	74
Commitments and contingent liabilities		
Stockholders' equity:		
Preferred stock, \$1.00 par value; 1,000,000 shares authorized, none outstanding	-	-
	229	228

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Common stock, \$.01 par value; 70,000,000 shares authorized; issued and outstanding 22,929,901 as of September 30, 2015 and 22,808,761 as of December 31, 2014

Additional paid-in capital	102,585		103,756	
Accumulated other comprehensive loss	(70)	(29)
Accumulated deficit	(48,778)	(51,566)
Total stockholders' equity	53,966		52,389	
Total liabilities and stockholders' equity	\$ 57,510		\$ 55,893	

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue:				
Software licenses	\$ 2,076	\$ 3,077	\$ 5,997	\$ 6,759
Software maintenance	1,220	1,085	3,651	3,282
Services	652	1,585	2,727	3,931
Hardware	-	132	-	4,813
Royalties	93	148	299	626
Total revenue	4,041	6,027	12,674	19,411
Costs and expenses:				
Cost of hardware	-	90	-	3,403
Cost of services	416	615	1,532	1,697
Research and development	1,489	1,381	4,364	4,060
Selling and marketing	849	973	2,885	2,813
General and administrative	858	940	2,604	2,719
Total costs and expenses	3,612	3,999	11,385	14,692
Patent related income	-	2,127	-	2,127
Operating income	429	4,155	1,289	6,846
Other income/(expense)	-	-	12	(59)
Interest income	35	43	109	182
Income before provision for income taxes	464	4,198	1,410	6,969
Provision for (benefit from) income taxes	(1,733)	1,599	(1,378)	2,625
Net income	\$ 2,197	\$ 2,599	\$ 2,788	\$ 4,344
Net income per share – basic	\$ 0.10	\$ 0.11	\$ 0.12	\$ 0.19
Net income per share – diluted	\$ 0.10	\$ 0.11	\$ 0.12	\$ 0.19
Weighted-average shares – basic	22,930	22,804	22,888	22,687
Weighted-average shares - diluted	23,011	22,893	22,949	22,781
Comprehensive income:				
Net income	\$ 2,197	\$ 2,599	\$ 2,788	\$ 4,344
Other comprehensive income (net of tax):				

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Unrealized gains (losses) on available for sale securities	(1)	(67)	(41)	54
Comprehensive income	\$ 2,196	\$ 2,532	\$ 2,747	\$ 4,398

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, 2015 2014	
Cash flows from operating activities:		
Net income	\$2,788	\$4,344
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	474	405
Stock-based compensation	466	619
Reversal of reserve for uncertain tax positions	(1,913)	-
Gain on sale of patent assets	-	(2,127)
Amortization of premium on investments	(8)	(1)
Deferred tax provision on other comprehensive income	21	(44)
(Gain)/loss on sale of investments	(12)	59
Changes in assets and liabilities:		
Accounts receivable	1,210	632
Inventories	(614)	1,599
Prepaid expenses and other current assets	(440)	260
Deferred tax assets	54	202
Accounts payable	39	(1,337)
Accrued expenses	(56)	58
Accrued income taxes	-	57
Deferred revenue	56	832
Net cash provided by operating activities	2,065	5,558
Cash flows from investing activities:		
Purchases of property and equipment	(117)	(112)
Sales of investments	529	1,432
Proceeds from sale of patent assets, net	-	2,127
Purchase of other assets	(320)	-
Net cash provided by investing activities	92	3,447
Cash flows from financing activities:		
Proceeds from issuance of common stock	22	491
Payment of dividends	-	(39,905)
Excess tax benefits from stock-based compensation	413	1,461

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Payments made for taxes of employees who surrendered shares related to unrestricted stock	(156)	(205)
Net cash provided by (used in) financing activities	279	(38,158)
Increase/(decrease) in cash and cash equivalents	2,436	(29,153)
Cash and cash equivalents, beginning of period	43,985	72,660
Cash and cash equivalents, end of period	\$46,421	\$43,507
Supplemental disclosure:		
Cash paid for income taxes	\$356	\$617

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

AWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

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

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

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

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

Cash and cash equivalents, which primarily include money market mutual funds, were \$46.4 million and \$44.0 million as of September 30, 2015 and December 31, 2014, respectively. We classified our cash equivalents of \$34.3 million and \$34.3 million as of September 30, 2015 and December 31, 2014 within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

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Our investments, which consist of high yield corporate debt securities, are also classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices. We categorize our investments as available-for-sale securities, and carry them at fair value in our financial statements. We had \$0.9 million and \$1.4 million of available-for-sale investments as of September 30, 2015 and December 31, 2014, respectively.

As of September 30, 2015, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

	Fair Value Measurement at September 30, 2015 Using:		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Corporate debt securities	\$ 858	\$ -	\$ -
Money market funds (included in cash and cash equivalents)	34,322		
Total	\$ 35,180	\$ -	\$ -

As of December 31, 2014, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

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

C) **Inventories.** Inventories are stated at the lower of cost or net realizable value with cost being determined by the first-in, first-out (“FIFO”) method. Inventories consisted of the following (in thousands):

	September 30, 2015	December 31, 2014
Raw materials	\$ 616	\$ 2
Finished goods	-	-
Total	\$ 616	\$ 2

D) **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		Nine Months Ended	
	September 30, 2015	2014	September 30, 2015	2014
Net income	\$ 2,197	\$ 2,599	\$ 2,788	\$ 4,344
Shares outstanding:				
Weighted-average common shares outstanding	22,930	22,804	22,888	22,687

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Additional dilutive common stock equivalents	81	89	61	94
Diluted shares outstanding	23,011	22,893	22,949	22,781
Net income per share – basic	\$ 0.10	\$ 0.11	\$ 0.12	\$ 0.19
Net income per share - diluted	\$ 0.10	\$ 0.11	\$ 0.12	\$ 0.19

For the three month periods ended September 30, 2015 and 2014, options to purchase 64,034 and 40,834 shares of common stock were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

For the nine month periods ended September 30, 2015 and 2014, options to purchase 54,034 and 40,834 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2015	2014	September 30, 2015	2014
Cost of services	\$ 9	\$ 15	\$ 23	\$ 30
Research and development	29	34	56	71
Selling and marketing	4	6	9	12
General and administrative	181	242	378	506
Stock-based compensation expense	\$ 223	\$ 297	\$ 466	\$ 619

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

Unrestricted Stock Grants. We also grant unrestricted shares of stock under our 2001 Nonqualified Stock Plan. Stock-based compensation expense for stock grants is determined based on the fair market value of our stock on the date of grant, provided the number of shares in the grant is fixed on the grant date.

We granted shares of unrestricted stock in 2015 and 2014 that affected financial results for the three and nine month periods ended September 30, 2015 and 2014. These grants are described below.

2015 Grant. On March 26, 2015, we granted 152,000 shares of unrestricted stock to directors, officers and employees. Half of those shares were issued on July 1, 2015 and the remaining 76,000 shares will be issued shortly after December 31, 2015, provided each grantee is serving as a director, officer or employee on that date. The total stock-based compensation expense related to this grant is \$682,000, of which \$223,000 and \$459,000 were charged to expense in the three and nine months ended September 30, 2015, respectively. We anticipate the remaining \$223,000 will be charged to expense in the fourth quarter of 2015.

The shares we issued on July 1, 2015 for the first installment of the 2015 grant included 58,862 net shares of common stock after employees surrendered 17,138 shares for which we paid \$69,000 of withholding taxes on their behalf.

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

F) **Business Segments.** We organize ourselves into a single segment that reports to the chief operating decision makers.

We conduct our operations in the United States and sell our products and services to domestic and international customers. Revenues were generated from the following geographic regions for the three and nine months ended September 30, 2015 and 2014 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2015	2014	September 30, 2015	2014
United States	\$ 2,579	\$ 4,154	\$ 7,594	\$ 14,945
Brazil	157	22	1,810	460
Rest of World	1,305	1,851	3,270	4,006
	\$ 4,041	\$ 6,027	\$ 12,674	\$ 19,411

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

	Three Months Ended		Nine Months Ended	
	September 30, 2015	2014	September 30, 2015	2014
Biometrics	\$ 3,575	\$ 5,510	\$ 11,306	\$ 17,720
Imaging	373	369	1,069	1,065
DSL royalties	93	148	299	626
	\$ 4,041	\$ 6,027	\$ 12,674	\$ 19,411

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

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

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

Income Taxes. Income tax expense was \$1.6 million and \$2.6 million for the three and nine months ended H) September 30, 2014, respectively. Income tax expense in the three and nine month periods of 2014 was based on the U.S. statutory rate of 34%, increased by state income taxes.

We recorded income tax benefits in the three and nine month periods ended September 30, 2015 of \$1.7 million and \$1.4 million, respectively. Income tax benefits in the three and nine month periods of 2015 were the result of a \$1.9 million tax benefit from the reversal of a reserve for uncertain tax positions, which was partially offset by taxes on pre-tax income based on the U.S. statutory rate of 34%, increased by state income taxes.

As previously reported, the Internal Revenue Service (“IRS”) commenced an examination of our tax return for the year ended December 31, 2012 in September 2014. In July 2015, the IRS notified us that it had completed its examination and that it had no changes to our reported tax. As a result of the completion of the IRS examination, we determined that a \$1.9 million reserve for uncertain tax positions we had established on federal research and development credits was no longer required. We reversed the reserve in the current quarter.

In the nine month periods ended September 30, 2015 and 2014, we utilized deferred tax assets to reduce our tax liability payable to the government. A portion of the deferred tax assets we used comprised cumulative deductions for stock options in excess of book expense. Under income tax accounting rules, that portion of tax benefits attributable to such deductions must be recorded as an adjustment to equity versus a reduction of income tax expense. The tax benefits from such stock-based awards were \$0.4 million and \$1.5 million in the nine month periods ended September 30, 2015 and 2014, respectively. These tax benefits were recorded as an equity adjustment to additional paid-in capital.

As of September 30, 2015, we had a total of \$0.9 million of deferred tax assets for which we had recorded no valuation allowance. We will continue to assess the level of valuation allowance in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

In addition to deferred tax assets carried on our balance sheet, we also had net federal and state research and development credit carryforwards available at December 31, 2014 of \$4.0 million and \$0.3 million. Federal credits of \$4.0 million would be adjusted to \$5.9 million after giving effect to the current quarter reversal of the reserve for uncertain tax positions. Our federal and state credits were not recorded as tax assets as they relate to excess stock compensation deductions that may not be recorded as tax assets under generally accepted accounting principles until the amounts have been utilized to reduce our tax liability. To the extent that these assets are used to reduce future taxes, the benefit will be recorded as a reduction to additional paid-in capital. The aforementioned \$0.4 million and \$1.5 million equity adjustment to additional paid-in capital in the nine month periods ended September 30, 2015 and 2014 were related to these deferred tax assets.

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

	December 31, 2014	Increase/ Decrease	Reclassification Adjustments	September 30, 2015
Unrealized losses on available for sale securities	\$ (87)	\$ (64)	\$ -	\$ (151)
Unrealized gains on available for sale securities	43	(10)	12	45

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Net unrealized gains (losses) on available for sale securities	(44)	(74)	12	(a)	(106)
Income tax benefit (expense) on other comprehensive loss	15	25	(4)		36
Total accumulated other comprehensive loss, net of taxes	\$ (29)	\$ (49)	\$ 8		\$ (70)

(a) – Classified in other income.

ITEM 2:

Management's Discussion and Analysis of

Financial Condition and Results of Operations

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

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

Summary of Operations

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

Summary of Financial Results

Revenue and net income for the three months ended September 30, 2015 were \$4.0 million and \$2.2 million, respectively. These results compared to revenue of \$6.0 million and net income of \$2.6 million in the three months ended September 30, 2014.

Lower revenue in the current quarter was primarily due to:

- i) A \$1.0 million decrease in sales of software licenses from \$3.1 million in the year ago quarter to \$2.1 million in the current quarter; and
- ii) A \$0.9 million decrease in services revenue from \$1.6 million in the year ago quarter to \$0.7 million in the current quarter.

Lower net income in the current quarter was primarily due to:

- i) Lower sales of software and services;
The year ago quarter included \$2.1 million of patent related income from the sale of patents, whereas the current quarter did not include any patent related income.
- ii) The effect of lower sales and patent related income in the current period was partially offset by a \$1.9 million tax benefit adjustment related to the reversal of a reserve for uncertain tax positions.

Revenue and net income for the nine months ended September 30, 2015 were \$12.7 million and \$2.8 million, respectively. These results compared to revenue of \$19.4 million and net income of \$4.3 million in the nine months ended September 30, 2014.

Lower revenue in the current nine month period was primarily due to:

- i) A \$0.8 million decrease in sales of software licenses from \$6.8 million in the nine month period in 2014 to \$6.0 million in the same nine month period in 2015;
- ii) A \$1.2 million decrease in services revenue from \$3.9 million in the nine month period in 2014 to \$2.7 million in the same nine month period in 2015; and
- iii) A \$4.8 million decrease in hardware sales from \$4.8 million in the nine month period in 2014 to zero in the same nine month period in 2015.

Lower net income in the current nine month period was primarily due to:

- i) Lower sales of software, services and hardware;
- ii) The year ago nine month period included \$2.1 million of patent related income from the sale of patents, whereas the current year period did not include any patent related income.
- iii) The effect of lower sales and patent related income in the current nine month period was partially offset by a \$1.9 million tax benefit adjustment related to the reversal of a reserve for uncertain tax positions.

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

Results of Operations

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

Software license revenue decreased 33% from \$3.1 million in the three months ended September 30, 2014 to \$2.1 million in the same three month period in 2015. As a percentage of total revenue, software license revenue was unchanged at 51% in both quarters.

Software license revenue decreased 11% from \$6.8 million in the nine months ended September 30, 2014 to \$6.0 million in the same nine month period in 2015. As a percentage of total revenue, software license revenue increased from 35% in the first nine months of 2014 to 47% in the corresponding period of 2015.

For the three and nine month periods ended September 30, 2015, the dollar decrease in software license revenue was primarily due to a \$1.0 million sale to a government agency in the third quarter of 2014. We did not have a government sale of that magnitude in 2015.

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

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

Software maintenance revenue increased 12% from \$1.1 million in the three months ended September 30, 2014 to \$1.2 million in the same three month period in 2015. As a percentage of total revenue, software maintenance revenue increased from 18% in the third quarter of 2014 to 30% in the current year quarter.

Software maintenance revenue increased 11% from \$3.3 million in the nine months ended September 30, 2014 to \$3.7 million in the same nine month period in 2015. As a percentage of total revenue, software maintenance revenue increased from 17% in the first nine months of 2014 to 29% in the corresponding period of 2015.

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

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

Services decreased 60% from \$1.6 million in the three months ended September 30, 2014 to \$0.7 million in the same three month period in 2015. As a percentage of total revenue, services decreased from 26% in the third quarter of 2014 to 16% in the current year quarter.

Services decreased 31% from \$3.9 million in the nine months ended September 30, 2014 to \$2.7 million in the same nine month period in 2015. As a percentage of total revenue, services increased from 20% in the first nine months of 2014 to 22% in the corresponding period of 2015.

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

Services revenue in the fourth quarter of 2015 is likely to decline compared to the comparable period in 2014 as two of the three government projects described above have been completed.

Hardware. Hardware revenue consists of sales of biometrics equipment to a single U.S. government customer for whom we developed biometrics software. Hardware products sold to this customer integrate hardware purchased from third parties with software from other third parties as well as software from Aware. We evaluated the classification of gross versus net revenue recognition and determined gross recognition was appropriate.

Hardware sales decreased 100% from \$0.1 million in the three months ended September 30, 2014 to zero in the same three month period in 2015. As a percentage of total revenue, hardware sales decreased from 2% in the third quarter of 2014 to 0% in the current year quarter.

Hardware sales decreased 100% from \$4.8 million in the nine months ended September 30, 2014 to zero in the same nine month period in 2015. As a percentage of total revenue, hardware sales decreased from 25% in the first nine months of 2014 to 0% in the corresponding period of 2015.

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

In April 2015, we received a \$1.1 million hardware order that we expect to deliver in the fourth quarter of 2015. In September 2015, we received another hardware order for \$0.3 million that we expect to deliver over the next quarter or two. Notwithstanding these orders, future orders from this customer may be minimal as we believe it has completed the bulk of its purchasing. Despite this expectation, we are unable to predict future hardware sales with any degree of certainty because forecasting our customer's demand is difficult.

It is worth noting that our strategy does not include maintaining or growing biometrics hardware revenue. We agreed to provide hardware products as an accommodation to an important customer.

Royalties. Royalties consist primarily of royalty payments we receive under DSL silicon contracts with two customers that incorporate our silicon intellectual property (“IP”) in their DSL chipsets. We sold our DSL IP business in 2009, but we continue to receive royalty payments from these customers. Royalties are reported in continuing operations in accordance with ASC 205-20, Reporting Discontinued Operations, because we have continuing ongoing cash flows from this business.

Royalties decreased 37% from \$148,000 in the three months ended September 30, 2014 to \$93,000 in the same three month period in 2015. As a percentage of total revenue, royalties were unchanged at 2% in the third quarters of 2014 and 2015.

Royalties decreased 52% from \$626,000 in the nine months ended September 30, 2014 to \$299,000 in the same nine month period in 2015. As a percentage of total revenue, royalties decreased from 3% in the first nine months of 2014 to 2% in the corresponding period of 2015.

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

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

Cost of hardware sales decreased 100% from \$90,000 in the three months ended September 30, 2014 to zero in the same three month period in 2015. Cost of hardware as a percentage of hardware sales was 68% in the prior year quarter, which means that product gross margins were 32% in the third quarter of 2014.

Cost of hardware sales decreased 100% from \$3.4 million in the nine months ended September 30, 2014 to zero in the same nine month period in 2015. Cost of hardware as a percentage of hardware sales was 71% in the first nine months of 2014, which means that product gross margins were 29% in that period.

For the three and nine month periods ended September 30, 2015, the dollar decrease in cost of hardware was due to the lack of hardware shipments in the current year periods.

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

Cost of services decreased 32% from \$615,000 in the three months ended September 30, 2014 to \$416,000 in the same three month period in 2015. Cost of services as a percentage of services increased from 39% in the third quarter of 2014 to 64% in the current quarter, which means that gross margins on services decreased from 61% to 36%.

Cost of services decreased 10% from \$1.7 million in the nine months ended September 30, 2014 to \$1.5 million in the same nine month period in 2015. Cost of services as a percentage of services increased from 43% in the first nine months of 2014 to 56% in the corresponding period in 2015, which means that gross margins on services decreased from 57% to 44%.

For the three and nine month periods ended September 30, 2015, the dollar decrease in cost of services was due to lower services revenue. The decline in the services margin percentages was primarily due to two factors:

As described in the services revenue section above, we completed a large project with a U.S. government customer i) in the third quarter of 2015. We incurred unexpected labor hours to resolve issues identified during final software testing. We believe those issues were resolved in the third quarter.

- ii) We also incurred more labor hours on several other customer projects than we expected at the time we quoted those projects.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Research and development expense	\$ 1,489	\$ 1,381	\$ 4,364	\$ 4,060
Cost of services	416	615	1,532	1,697
Total engineering costs	\$ 1,905	\$ 1,996	\$ 5,896	\$ 5,757

Research and development expense increased 8% from \$1.4 million in the three months ended September 30, 2014 to \$1.5 million in the same three month period in 2015. As a percentage of total revenue, research and development expense increased from 23% in the third quarter of 2014 to 37% in the corresponding period of 2015.

Research and development expense increased 7% from \$4.1 million in the nine months ended September 30, 2014 to \$4.4 million in the same nine month period in 2015. As a percentage of total revenue, research and development expense increased from 21% in the first nine months of 2014 to 34% in the corresponding period of 2015.

For the three and nine month periods ended September 30, 2015, the dollar increase in research and development expense was primarily due to engineers rotating off customer projects onto internal development projects.

As the table immediately above indicates, total engineering costs in the three month period ended September 30, 2015 were \$0.1 million lower than the corresponding period in 2014. The slight spending decline was primarily due to lower spending on contractors which was partially offset by a small number of net headcount additions. Lower

contractor spending was the result of two actions: i) in the second quarter of 2015, we terminated several contractors who worked on the large project with the U.S. government; and ii) at the end of the third quarter of 2014, we terminated several contractors who worked on internal development projects.

Total engineering costs in the nine month period ended September 30, 2015 were \$0.1 million higher than the corresponding period in 2014. The spending increase in the current nine month period primarily reflects increased spending on several 2015 headcount additions that were mostly offset by lower spending on the aforementioned contractors and recruiting fees.

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

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

Sales and marketing expense decreased 13% from \$1.0 million in the three months ended September 30, 2014 to \$0.8 million in the same three month period of 2015. As a percentage of total revenue, sales and marketing expense increased from 16% in the third quarter of 2014 to 21% in the corresponding period of 2015. The dollar decrease in selling and marketing expense was primarily due to lower sales commissions on lower revenue.

Sales and marketing expense increased 3% from \$2.8 million in the nine months ended September 30, 2014 to \$2.9 million in the same nine month period of 2015. As a percentage of total revenue, sales and marketing expense increased from 14% in the first nine months of 2014 to 23% in the corresponding period of 2015. The dollar increase in selling and marketing expense was primarily due the addition of one employee in our sales organization over the past year.

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

General and administrative expense decreased 9% from \$940,000 in the three months ended September 30, 2014 to \$858,000 in the same three month period of 2015. As a percentage of total revenue, general and administrative expense increased from 16% in the third quarter of 2014 to 21% in the current year quarter.

General and administrative expense decreased 4% from \$2.7 million in the nine months ended September 30, 2014 to \$2.6 million in the same nine month period in 2015. As a percentage of total revenue, general and administrative expense increased from 14% in the first nine months of 2014 to 21% in the corresponding period in 2015.

For the three and nine month periods ended September 30, 2015, the dollar decrease in general and administrative expense was primarily due to lower stock-based compensation and patent filing costs.

Patent related income. We had no patent related income in the three and nine months ended September 30, 2015, and \$2.1 million of such income in the three and nine months ended September 30, 2014.

Patent related income in 2014 consisted of a gain on the sale of patent assets. We sold a portion of our patent portfolio pertaining to DSL diagnostic technology to an unrelated third party for \$2.6 million. The proceeds from the sale were reduced by \$0.5 million of transaction costs, which consisted primarily of fees from the law firm that assisted us in the sale. We recorded a gain of \$2.1 million on the sale.

The DSL diagnostic technology in these patents was related to our DSL Service Assurance business that we shut down in 2012 and 2013 and reported in discontinued operations in those periods. We do not consider our patent related activities to be a component of the operating business from which the underlying technology was derived, but rather as a component of corporate general and administrative expenses. Accordingly the gain on the sale of these patents was reported in income from continuing operations pursuant to ASC 360, Impairment or Disposal of Long-Lived Assets, and Rule 5-03 of Regulation S-X.

Other income/(expense). We did not record any other income/(expense) in the three months ended September 30, 2015 and 2014.

We recorded \$12,000 of other income in the nine months ended September 30, 2015. This income represented a realized gain on the sale of a high yield bond.

We recorded \$59,000 of other expense in the nine months ended September 30, 2014. This expense represented realized losses on the sale of two high yield bonds.

Interest income. Interest income decreased 19% from \$43,000 in three months ended September 30, 2014 to \$35,000 in the same three month period in 2015.

Interest income decreased 40% from \$182,000 in the nine months ended September 30, 2014 to \$109,000 in the same nine month period in 2015.

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

Income Taxes. Income tax expense was \$1.6 million and \$2.6 million for the three and nine months ended September 30, 2014, respectively. Income tax expense in the three and nine month periods of 2014 was based on the U.S. statutory rate of 34%, increased by state income taxes.

We recorded income tax benefits in the three and nine month periods ended September 30, 2015 of \$1.7 million and \$1.4 million, respectively. Income tax benefits in the three and nine month periods of 2015 were the result of a \$1.9 million tax benefit from the reversal of a reserve for uncertain tax positions, which was partially offset by taxes on pre-tax income based on the U.S. statutory rate of 34%, increased by state income taxes.

As previously reported, the Internal Revenue Service (“IRS”) commenced an examination of our tax return for the year ended December 31, 2012 in September 2014. In July 2015, the IRS notified us that it had completed its examination and that it had no changes to our reported tax. As a result of the completion of the IRS examination, we determined that a \$1.9 million reserve for uncertain tax positions we had established on federal research and development credits was no longer required. We reversed the reserve in the current quarter.

In the nine month periods ended September 30, 2015 and 2014, we utilized deferred tax assets to reduce our tax liability payable to the government. A portion of the deferred tax assets we used comprised cumulative deductions for stock options in excess of book expense. Under income tax accounting rules, that portion of tax benefits attributable to such deductions must be recorded as an adjustment to equity versus a reduction of income tax expense. The tax benefits from such stock-based awards were \$0.4 million and \$1.5 million in the nine month periods ended September

30, 2015 and 2014, respectively. These tax benefits were recorded as an equity adjustment to additional paid-in capital.

As of September 30, 2015, we had a total of \$0.9 million of deferred tax assets for which we had recorded no valuation allowance. We will continue to assess the level of valuation allowance in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

In addition to deferred tax assets carried on our balance sheet, we also had net federal and state research and development credit carryforwards available at December 31, 2014 of \$4.0 million and \$0.3 million. Federal credits of \$4.0 million would be adjusted to \$5.9 million after giving effect to the current quarter reversal of the reserve for uncertain tax positions. Our federal and state credits were not recorded as tax assets as they relate to excess stock compensation deductions that may not be recorded as tax assets under generally accepted accounting principles until the amounts have been utilized to reduce our tax liability. To the extent that these assets are used to reduce future taxes, the benefit will be recorded as a reduction to additional paid-in capital. The aforementioned \$0.4 million and \$1.5 million equity adjustment to additional paid-in capital in the nine month periods ended September 30, 2015 and 2014 were related to these deferred tax assets.

Liquidity and Capital Resources

At September 30, 2015, we had cash and cash equivalents of \$46.4 million, which represented an increase of \$2.4 million from December 31, 2014. The increase in cash and cash equivalents was primarily due to the following factors:

Cash provided by operations was \$2.1 million in the first nine months of 2015, which was after a reduction of \$413,000 for non-cash excess tax benefits from stock-based compensation included in prepaid expenses. Cash provided by operations was primarily the result of: i) net income; ii) the add back of non-cash items for depreciation, amortization, and stock-based compensation; and iii) the reduction of accounts receivables through collections. These positive cash flow factors were partially offset by a \$0.6 million increase in inventory. The inventory was for an order we expected to deliver next quarter.

Cash provided by investing activities of \$92,000 consisted of \$529,000 from sales of investments less \$320,000 used to purchase a technology license and \$117,000 of purchases of property and equipment.

Cash provided by financing activities of \$279,000 consisted of: i) \$413,000 of excess tax benefits from stock-based compensation; and ii) \$22,000 of proceeds from our employee stock purchase plan. Cash provided by these two activities was partially offset by \$156,000 of cash used to pay income taxes for employees who surrendered shares in connection with stock grants.

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

Recent Accounting Pronouncements

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

ITEM 3:

Quantitative and Qualitative Disclosures about Market Risk

Our exposure to market risk relates primarily to our investment portfolio, and the effect that changes in interest rates would have on that portfolio. Our investment portfolio at September 30, 2015 consisted of two elements:

Cash and cash equivalents. As of September 30, 2015, our cash and cash equivalents of \$46.4 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.

Investments. As of September 30, 2015, our investments of \$0.9 million were invested in high yield bonds with two corporate debt issuers, which mature in 2017 and 2018. While we are exposed to default risk, the high current yield of these bonds largely mitigates interest rate risk. Therefore, due to the high current yield and the three to four year life of these instruments, we do not believe that a general increase in interest rates would result in any material loss.

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

ITEM 4:

Controls and Procedures

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

PART II. OTHER INFORMATION

ITEM 1:

Legal Proceedings

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

ITEM 1A:

Risk Factors

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

ITEM 4:

Mine Safety Disclosures

Not applicable.

ITEM 6:

Exhibits

(a) Exhibits

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

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

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

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

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

SIGNATURES

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

AWARE, INC.

Date: October 27, 2015 By: /s/ Kevin T. Russell
Kevin T. Russell
co-Chief Executive Officer & co-President
General Counsel

Date: October 27, 2015 By: /s/ Richard P. Moberg
Richard P. Moberg
co-Chief Executive Officer & co-President
Chief Financial Officer (Principal Financial and Accounting Officer)