AWARE INC /MA/
Form 10-Q
April 29, 2010

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 March 31, 2010

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 o

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 o NO o

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 o Accelerated Filer x Non-Accelerated Filer o Smaller Reporting Company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES o NO x

Indicate the number of shares outstanding of the issuer's common stock as of April 26, 2010:

Class	Number of Shares Outstanding
Common Stock, par value $0.01 per share	19,926,970 shares

AWARE, INC.
FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2010

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PART 1. FINANCIAL INFORMATION

ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS

AWARE, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

(unaudited)

	March 31, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$39,020	$39,669
Accounts receivable, net	4,197	3,565
Inventories	1,090	1,113
Prepaid expenses and other current assets	499	363
Total current assets	44,806	44,710
Property and equipment, net	6,662	6,744
Other assets, net	38	-
Total assets	$51,506	$51,454
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$611	$327
Accrued expenses	95	127
Accrued compensation	780	1,202
Accrued professional	191	282
Deferred revenue	679	563
Total current liabilities	2,356	2,501
Long-term deferred revenue	585	593
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 19,926,970 as of March 31, 2010 and 19,809,315 as of December 31, 2009	199	198
Additional paid-in capital	76,215	76,032
Accumulated deficit	(27,849)	(27,870)
Total stockholders' equity	48,565	48,360
Total liabilities and stockholders' equity	$51,506	$51,454

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 March 31, 2010	Three Months Ended March 31, 2009
Revenue:		
Product sales	$4,651	$2,819
Contract revenue	209	1,277
Royalties	756	477
Total revenue	5,616	4,573
Costs and expenses:		
Cost of product sales	1,036	513
Cost of contract revenue	72	908
Research and development	2,035	3,111
Selling and marketing	1,066	1,081
General and administrative	1,402	1,213
Total costs and expenses	5,611	6,826
Income (loss) from operations	5	(2,253)
Interest income	18	125
Income (loss) before provision for income taxes	23	(2,128)
Provision for income taxes	1	3
Net income (loss)	$22	$(2,131)
Net income (loss) per share – basic	$0.00	$(0.09)
Net income (loss) per share – diluted	$0.00	$(0.09)
Weighted average shares – basic	19,913	23,281
Weighted average shares - diluted	19,923	23,281

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

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

	Three Months Ended March 31, 2010	2009
Cash flows from operating activities:		
Net income (loss)	$22	$(2,131)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	129	227
Stock-based compensation	345	391
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	(633)	(1,215)
Inventories	23	98
Prepaid expenses	(137)	(294)
Accounts payable	247	193
Accrued expenses	(445)	(156)
Deferred revenue	108	(42)
Net cash used in operating activities	(341)	(2,929)
Cash flows from investing activities:		
Purchases of property and equipment	(47)	(74)
Expenses from sale of assets	(100)	-
Net cash used in investing activities	(147)	(74)
Cash flows from financing activities:		
Shares surrendered by employees to pay taxes related to unrestricted stock	(161)	-
Net cash used in financing activities	(161)	-
Decrease in cash and cash equivalents	(649)	(3,003)
Cash and cash equivalents, beginning of period	39,669	45,516
Cash and cash equivalents, end of period	$39,020	$42,513

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 March 31, 2010, and of operations and cash flows for the interim periods ended March 31, 2010 and 2009.

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, 2009 in conjunction with our 2009 Annual Report on Form 10-K. This Form 10-Q should be read in conjunction with that Form 10-K.

The results of operations for the interim period ended March 31, 2010 are not necessarily indicative of the results to be expected for the year.

B) Fair Value Measurements

The FASB issued authoritative guidance for fair value measurements in September 2006, which defines fair value, establishes a framework for measuring fair value, and expands disclosures assets and liabilities measured at fair value in financial statements. This guidance is set forth in FASB Accounting Standards Codification 820 (ASC 820). We adopted the provisions of ASC 820 as of January 1, 2008, for our financial instruments. Although the adoption of ASC 820 did not materially impact our financial condition, results of operations, or cash flow, we are now required to provide additional disclosures as part of our financial statements.

The fair value guidance establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

For recognition purposes, on a recurring basis we are required to measure available for sale investments at fair value. We had no available for sale investments as of March 31, 2010 or December 31, 2009.

Our cash and cash equivalents, including money market securities, were $39.0 million and $39.7 million as of March 31, 2010 and December 31, 2009, respectively. We classified our cash and cash equivalents within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

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. Inventory reserves are established for estimated excess and obsolete inventory. Inventories consist primarily of the following (in thousands):

	March 31, 2010	December 31, 2009
Raw materials	$1,089	$1,112
Finished goods	1	1
Total	$1,090	$1,113

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Net income (loss)	$ 22	$ (2,131)
Weighted average common shares outstanding	19,913	23,281
Additional dilutive common stock equivalents	10	-
Diluted shares outstanding	19,923	23,281
Net income (loss) per share – basic	$ 0.00	$ (0.09)
Net income (loss) per share – diluted	$ 0.00	$ (0.09)

For the three month period ended March 31, 2009, potential common stock equivalents of 195 were not included in the per share calculation for diluted EPS, because we had a net loss and the effect of their inclusion would be anti-dilutive.

For the three month periods ended March 31, 2010 and 2009, options to purchase 4,958,841 and 7,499,993 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 operations (in thousands):

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Cost of product sales	$ 2	$ 3
Cost of contract revenue	6	32
Research and development	114	146
Selling and marketing	38	52
General and administrative	185	158
Stock-based compensation expense	$ 345	$ 391

We estimate the fair value of stock options using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. These 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. 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 March 31, 2009. No options were granted in the three months ended March 31, 2010. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

In January 2010, we completed an employee option exchange program. Under the terms of the program, eligible rank and file employees had the right to exchange eligible vested and unvested stock options outstanding for shares of common stock. Exchange ratios for each eligible stock option were determined using the fair values of stock options and Aware's common stock immediately prior to the initiation of the program.

When the program ended on January 12, 2010, eligible employees had exchanged 820,481 stock options for 178,314 shares of common stock. Participating employees were allowed to surrender a portion of their common stock in return for the Company paying withholding taxes related to their stock grants. As a result of this provision, employees surrendered 60,659 shares of common stock and the Company paid approximately $161,000 of withholding taxes on their behalf. After the common stock share surrender, 117,655 net shares of common stock were issued to participating employees.

A portion of the 820,481 stock options that were exchanged were not fully vested as of the exchange date. We expensed approximately $102,000 of unamortized stock-based compensation related to such unvested stock options in the three months ended March 31, 2010.

F) Business Segments

We organize our self as one segment and conduct our operations in the United States.

We sell our products and technology to domestic and international customers. Revenues were generated from the following geographic regions (in thousands):

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
United States	$ 3,452	$ 2,525
Germany	644	1,034
Rest of World	1,520	1,014
	$ 5,616	$ 4,573

G) Income Taxes

As of December 31, 2009, we had federal net operating loss (“NOLs”) and research and experimentation credit carryforwards of approximately $47.6 million and $13.4 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2010 through 2029. In addition, at December 31, 2009, we had approximately $10.3 million and $7.1 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2010 through 2024.

Based on an analysis that we performed under Internal Revenue Code Section 382 on our NOLs generated for the period 1997 through 2009, we have not experienced a change in ownership as defined by Section 382, and, therefore, the NOLs are not currently under any Section 382 limitation.

H) Recent Accounting Pronouncements

We describe below recent pronouncements that have had or may have a significant effect on our financial statements. We do not discuss recent pronouncements that are not anticipated to have an impact on or are unrelated to our financial condition, results of operations, or disclosures.

In January 2010, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2010-06, “Improving Disclosures about Fair Value Measurements”. ASU 2010-06 requires additional disclosures about fair value measurements including transfers in and out of Levels 1 and 2 and a higher level of disaggregation for the different types of financial instruments. For the reconciliation of Level 3 fair value measurements, information about purchases, sales, issuances and settlements are presented separately. This standard is effective for interim and annual reporting periods beginning after December 15, 2009 with the exception of revised Level 3 disclosure requirements which are effective for interim and annual reporting periods beginning after December 15, 2010. Comparative disclosures are not required in the year of adoption. We adopted the provisions of the standard on January 1, 2010, which did not have a material impact on our financial statements.

I) Share Repurchase Program

On March 5, 2009, we announced a modified Dutch auction self-tender offer to purchase up to 3,500,000 shares, or approximately 15%, of our outstanding common stock (including the associated preferred share purchase rights), at a price in the range of $2.20 to $2.60 per share, for a maximum aggregate purchase price of approximately $9.1 million. The terms of the tender offer also provided the right for us to purchase up to an additional 2% of our shares if the offer was oversubscribed.

The tender offer closed on April 17, 2009, and on April 23, 2009 we repurchased 3,500,252 shares at $2.50 per share for a total cost of $9.0 million, including expenses.

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.

Summary. We have historically organized ourselves as one segment with three product lines. Our product lines have included: i) DSL test and diagnostics products, ii) biometrics products, and iii) licensing products.

Our test and diagnostics products consist of DSL hardware and software products that are used by telephone companies to improve the quality of their DSL service offerings. Our test and diagnostics products are typically sold to OEMs that incorporate our products into their products. Our OEM customers sell their equipment and software products to telephone companies. We also market our test and diagnostics software directly to telephone companies.

Our biometrics products consist of software and services used in biometric systems. Biometric systems are used by governments and enterprises to verify the identification of people. Biometrics systems are used in applications such as border control, secure credentialing, and background checks. We typically sell our biometrics software and services to OEMs and system integrators that incorporate our products into their biometrics hardware and software systems. We also sell a modest amount of medical imaging software that is included in our biometrics product line revenue.

Our licensing products have consisted of: i) DSL technology products, ii) home networking technology products, and iii) patents related to DSL, home networking and other technologies. Our technology products have been licensed to semiconductor companies that sell chipsets that incorporate our technology. Our patents are sold or licensed to third parties interested in acquiring such patent rights.

On November 13, 2009, we completed a transaction in which we sold substantially all of the assets associated with our licensing product line to Lantiq Deutschland GmbH ("Lantiq") for $6.75 million. Lantiq is a fabless semiconductor company that was spun out of Infineon Technologies AG ("Infineon"), our largest DSL licensing customer at that time. The sale included: i) our DSL and home networking technology assets; ii) certain patents and patent applications related to those technology assets; iii) a group of 41 engineers; and iv) lab and computer equipment used by the transferred engineers.

As a result of the Lantiq transaction, we will no longer derive DSL contract revenue from Infineon or Lantiq. Over the past several years, contract revenue from Infineon has ranged from $0.5 million to $1.0 million per quarter. We amended and restated the existing license agreement between us and Infineon to provide Lantiq (as successor to Infineon) certain non-exclusive licenses of our patent rights, and to continue Lantiq's royalty obligations to Aware. We also expect to continue to derive contract revenue for engineering support and royalties per our existing agreements with Ikanos Communications, Inc. ("Ikanos"). We will not be pursuing new silicon intellectual property licensing customers for DSL or home networking applications for the foreseeable future. In addition, Aware subleased certain office and lab space to Lantiq at its main facilities in Bedford, Massachusetts. In the first quarter of 2010, engineering expenses associated with our licensing product line decreased by approximately $1.8 million compared to the first quarter of 2009 as a result of the transfer of 41 engineers to Lantiq. We expect that quarterly engineering expenses in the second and third quarters of 2010 will decrease by $1.7 million to $2.0 million compared to the corresponding periods in 2009 as a result of the employee transfer.

After the sale of our licensing product line to Lantiq in November 2009, we have operated as one segment with two principal product lines: i) biometrics products; and ii) DSL test and diagnostics products. We expect that the Lantiq transaction will have a minimal impact on the future financial results of our biometrics and DSL test and diagnostics product lines. As it relates to our DSL test business, Aware and Lantiq will cooperate with one another with respect to embedded wireline diagnostics technology and products.

Net income in accordance with generally accepted accounting principles ("GAAP") for the three months ended March 31, 2010 was $22,000, or $0.00 per share. We had a GAAP net loss for the three months ended March 31, 2009 of $2.1 million, or $0.09 per share. Readers of this report should keep in mind that our financial results for the three months ended March 31, 2009 included the revenue and expense impact of the licensing product line that was sold to Lantiq in November 2009, whereas results for the three months ended March 31, 2010 no longer included such revenue and expenses. The royalty obligations of Lantiq and Ikanos were not affected by the Lantiq transaction and therefore royalty revenue is included in both three month periods ended March 31, 2010 and 2009.

The Company uses non-GAAP information internally to evaluate its operating performance and believes these non-GAAP measures are useful to investors as they provide additional insight into the underlying operating results. Our non-GAAP net income (loss) excludes the effect of stock-based compensation expense. Non-GAAP net income for the three months ended March 31, 2010, excluding the effect of $345,000 of stock-based compensation, was $367,000, or $0.02 per diluted share. We had a non-GAAP net loss for the three months ended March 31, 2009, excluding the effect of $391,000 of stock-based compensation, of $1.7 million, or $0.07 per diluted share. A reconciliation of GAAP to non-GAAP results is set forth in the table below (in thousands, except for per share amounts):

	Three Months Ended March 31,	
	2010	2009
GAAP net income (loss)	$ 22	$ (2,131)
Stock-based compensation	345	391
Non-GAAP net income (loss)	$ 367	$ (1,740)

	Three Months Ended March 31, 2010	2009
GAAP net income (loss) per diluted share	$ 0.00	$ (0.09)
Stock-based compensation per diluted share	0.02	0.02
Non-GAAP net income (loss) per diluted share	$ 0.02	$ (0.07)

Results of Operations

Product Sales. Product sales consist primarily of revenue from the sale of hardware and software products. Hardware products consist primarily of DSL test and diagnostics modules. Software products consist of software products, including maintenance contracts, for biometric, medical imaging and digital imaging applications, as well as DSL test and diagnostics software.

Product sales increased 65% from $2.8 million in the first quarter of 2009 to $4.7 million in the current year quarter. As a percentage of total revenue, product sales increased from 62% in the first quarter of 2009 to 83% in the current year quarter. The dollar increase in product sales was primarily due to a $0.9 million increase in revenue from the sale of test and diagnostic hardware and software, and a $1.0 million increase in revenue from the sale of biometrics software. The $0.9 million increase in revenue from the sale of test and diagnostic products was mainly attributable to a large hardware sale to an OEM customer that is deploying test equipment into a major service provider. The $1.0 million increase in revenue from the sale of biometrics software was primarily due to improving economic conditions in the current quarter, which led to increased customer demand.

We do not expect the Lantiq transaction to materially affect future product sales.

Contract Revenue. Contract revenue consists of patent, license and engineering service fees that we receive under agreements relating to the sale or license of Aware's patents, DSL technology, DSL test and diagnostic technology, and biometrics technology.

Contract revenue decreased 84% from $1.3 million in the first quarter of 2009 to $0.2 million in the current year quarter. As a percentage of total revenue, contract revenue decreased from 28% in the first quarter of 2009 to 4% in the current year quarter. The dollar decrease was primarily due to a $0.7 million decrease in contract revenue from DSL technology contracts, and a $0.4 million decrease in contract revenue from biometrics professional services contracts. The $0.7 million decrease in contract revenue from DSL technology contracts was mainly attributable to a decline in revenue as a result of the sale of our licensing product line to Lantiq in November 2009. The $0.4 million decrease in contract revenue from biometrics professional services contracts was primarily due to the completion of a significant customer project during 2009.

We expect that any contract revenue from DSL technology contracts will be minimal in future periods as a result of the sale of our licensing product line to Lantiq. Moreover, we will not be pursuing new silicon IP licensing customers for DSL or home networking applications in the foreseeable future. Other potential sources of future contract revenue include revenue from i) biometrics professional services contracts; ii) DSL test and diagnostic professional services contracts and 3) sales and/or licenses of patents. Although there were no patent sales in 2009 or the first quarter of 2010, we intend to continue to sell and/or license additional patents in the future, subject to customer demand and favorable terms and conditions.

Royalties. Royalties consist of royalty payments that we receive under agreements with our customers. We receive royalties from customers for rights to Aware technology and/or patents, typically associated with the incorporation of Aware technology and/or patents in customer chipsets.

Royalties increased 58% from $0.5 million in the first quarter of 2009 to $0.8 million in the current year quarter. As a percentage of total revenue, royalties increased from 10% in the first quarter of 2009 to 13% in the current year quarter. Most of the dollar increase in royalties was due to higher ADSL royalties reported to us by one of our licensees. We are unable to predict whether the increased royalties reported by this licensee in the current quarter will trend upward or downward in future quarters.

Our royalty revenue currently comes predominantly from ADSL chipset sales by Ikanos and ADSL and VDSL chipset sales by Lantiq (formerly Infineon). The Lantiq transaction will not alter the royalty obligations of Ikanos or Lantiq, which we expect to continue per the existing agreements with those parties. We remain uncertain as to whether these licensees will be able to maintain their market shares and chipset prices in the face of intense competition, and whether our relationships with them will contribute meaningful royalties to us in the future. Also, as a result of the Lantiq transaction, we will not be pursuing new silicon intellectual property licensing customers for DSL or home networking applications in the foreseeable future that might lead to royalties from new customers.

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 102% from $0.5 million in the first quarter of 2009 to $1.0 million in the current year quarter. As a percentage of product sales, cost of product sales increased from 18% in the first quarter of 2009 to 22% in the current year quarter, which means that product gross margins decreased from 82% to 78%. The cost of product sales dollar increase was primarily due to greater sales of test and diagnostics hardware products this quarter. The decrease in product gross margins was primarily due to a greater proportion of hardware product sales in product sales in the current quarter versus the year ago quarter.

Cost of Contract Revenue. Cost of contract revenue consists primarily of compensation costs for engineers and expenses for consultants, recruiting, supplies, equipment, depreciation and facilities associated with customer engineering services projects. Cost of contract revenue also includes direct expenses for third party contractors and consultants for biometrics professional services contracts. 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 decreased 92% from $0.9 million in the first quarter of 2009 to $0.1 million in the current year quarter. Cost of contract revenue as a percentage of contract revenue, was 71% in the first quarter of 2009 and 34% in the current quarter, which means that the gross margins on contract revenue increased from 29% to 66%. The dollar decrease in cost of contract revenue was primarily a function of lower revenue from DSL technology contracts and biometrics professional services contracts in the current quarter. The increase in gross margins on contract revenue is primarily due to higher margins on biometrics contracts, which represented a greater proportion of contract revenue in the current year quarter primarily as a result of the asset sale to Lantiq.

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 communications, test, biometrics and imaging technology, as well as our software and hardware products. 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.

Research and development expenses decreased 35% from $3.1 million in the first quarter of 2009 to $2.0 million in the current year quarter. As a percentage of total revenue, research and development expense decreased from 68% in the first quarter of 2009 to 36% in the current year quarter. The dollar decrease in research and development expense was primarily due to a $1.8 million reduction of engineering expenses as a result of the sale of our licensing product line to Lantiq. This expense reduction was partially offset by $0.6 million less engineering expenses allocated to cost of contract.

After the closing of the Lantiq transaction, our future research and development activities will be focused on developing biometrics and imaging software, and developing test and diagnostics hardware and software. We will also continue to expand our patent portfolio.

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 in the first quarter of 2010 was essentially unchanged at $1.1 million from the first quarter of 2009. As a percentage of total revenue, sales and marketing expense decreased from 24% in the first quarter of 2009 to 19% in the current year quarter.

Flat sales and marketing spending reflects a steady state sales and marketing organization. Moreover, since the Lantiq transaction did not involve any of our sales or marketing personnel, the transaction had a minimal impact on current quarter expenses and we expect that it will have a minimal impact on future sales and marketing expenses.

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 16% from $1.2 million in the first quarter of 2009 to $1.4 million in the current year quarter. As a percentage of total revenue, general and administrative expense decreased from 27% in the first quarter of 2009 to 25% in the current year quarter.

The dollar increase in general and administrative expense was mainly attributable to higher spending on legal fees, director fees, and stock-based compensation.

Since the Lantiq transaction did not involve any of our administrative personnel, the transaction had a minimal impact on current quarter expenses and we expect that it will have a minimal impact on future general and administrative expenses.

Interest Income. Interest income decreased 86% from $125,000 in the first quarter of 2009 to $18,000 in the current year quarter. The dollar decrease was primarily due to a significant decline in money market interest rates.

Income Taxes. We made no provision for income taxes in the first three months of 2010 and 2009 due to minimal net income in the 2010 period, net losses in the 2009 period, and the uncertainty of the timing of profitability in future periods. We did record $1,000 and $3,000 of state excise taxes in the first three months of 2010 and 2009, respectively. 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 March 31, 2010, 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.

As of December 31, 2009, we had federal net operating loss (“NOLs”) and research and experimentation credit carryforwards of approximately $47.6 million and $13.4 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2010 through 2029. In addition, at December 31, 2009, we had approximately $10.3 million and $7.1 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2010 through 2024.

Based on an analysis that we performed under Internal Revenue Code Section 382 on our NOLs generated for the period 1997 through 2009, we have not experienced a change in ownership as defined by Section 382, and, therefore, the NOLs are not currently under any Section 382 limitation.

Liquidity and Capital Resources

At March 31, 2010, we had cash and cash equivalents of $39.0 million, which represented a decrease of $649,000 from December 31, 2009. The decrease in cash was primarily due to: i) $341,000 of cash used by operations; ii) $47,000 of cash used to purchase capital equipment; iii) $161,000 of cash used to pay withholding taxes for employees who surrendered shares of common stock in connection with an employee option exchange program; and iv) $100,000 of transaction expenses paid in the first quarter of 2010 that related to the 2009 sale of assets to Lantiq.

We used $341,000 of cash in operations in the first three months of 2010. This cash usage was primarily the result of $837,000 of cash used to fund working capital items, which was partially offset by net income of $22,000, and non-cash items related to depreciation and amortization of $129,000, and stock based compensation expense of $345,000.

Capital spending was primarily related to the purchase of computer hardware, and laboratory equipment used principally in engineering activities.

In January 2010, we completed an employee option exchange program in which we allowed participating employees to surrender a portion of their shares of common stock in return for the Company paying withholding taxes related to their stock grants. As a result of this provision, employees surrendered 60,659 shares of common stock and we paid approximately $161,000 of withholding taxes on their behalf.

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 H 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 has included:

- Cash and cash equivalents, which consist of financial instruments with original maturities of three months or less;
- Short-term investments, which consist of financial instruments with remaining maturities of twelve months or less; and
- Investments, which consist of financial instruments that mature in three years or less.

All of our investments meet the high quality standards specified in our investment policy. This policy dictates the maturity period and limits the amount of credit exposure to any one issue, issuer, and type of instrument.

As of March 31, 2010, our cash and cash equivalents of $39.0 million were invested in money market accounts. Due to the nature and 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 March 31, 2010, we had no investments that matured in more than twelve months. We do not use derivative financial instruments for speculative or trading purposes.

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

GENERAL BUSINESS RISKS

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 due to the unpredictably of our revenue components.

It is difficult for us to make accurate forecasts of product revenues. Product revenues consist of sales of test and diagnostics hardware and software as well as biometrics and medical imaging software. Sales of hardware and software products fluctuate based upon demand by our customers which is difficult to predict. We generally ship customer orders as we receive them, and, therefore, we have no meaningful backlog of product orders. Since our product revenues include the sales of hardware products which typically have lower gross margins than our other sources of revenue, product gross margins and overall profitability are also difficult to predict.

Contract revenues are also unpredictable. Making accurate predictions regarding the timing of contract revenues from new and existing customers is difficult.

It is also difficult for us to make accurate forecasts of royalty revenues. Royalties are typically recognized in the quarter when we receive a report from a customer detailing sales and royalties due from the prior quarter, such as from the shipment of licensed integrated circuits. Royalties depend upon customer revenues which can be affected by factors beyond our ability to control or assess in advance. These factors include our customers' ability to generate sales and fluctuating sales volumes and prices of products containing our technology.

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

- market acceptance of our hardware and software products;
- fluctuations in the demand for our hardware and software products;
- competitive pressures resulting in lower software or hardware product revenues;
- the loss of a significant OEM relationship or termination of a professional services project by a customer;
- the loss by an OEM customer 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;
- pricing pressure from our competitors in the markets in which we compete;
- delays in the adoption of new industry standards or changes in market perception of the value of new or existing standards;
- personnel changes, particularly those involving engineering, technical, sales and marketing personnel;
- costs associated with protecting our intellectual property;
- the potential that customers could fail to make payments under their agreements with us;
- hardware manufacturing issues, including yield problems in our hardware platforms, and inventory buildup and obsolescence;
- product gross margins may be affected by various factors including, but not limited to, product mix, product life cycle, and provisions for excess and obsolete inventory;
- new laws, changes to existing laws, or 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 Have Experienced Net Losses

We had net losses in 2001, 2002, 2003, 2004, and 2005, and operating losses in 2006, 2007, and 2009. We may experience losses in the future if:

- the test and diagnostics or biometrics markets decline;
- new and/or existing customers do not choose to use our software or hardware products; or
- customers do not choose to license and/or buy our patents.

Our Business is Subject to Rapid Technological Change

The telecommunications and biometrics industries are characterized by rapid technological change and uncertainty. In these industries, new generations of products are introduced regularly and evolutionary improvements to existing products are required. Therefore, we face risks that others could introduce competing technologies that render our technologies and products less desirable or obsolete. Also, the announcement of new technologies could cause: i) our customers to delay purchasing our products; or ii) our customers' customers to delay purchasing OEM products that incorporate our products. 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 new generations of products as well as new technologies and products that keep pace with changes in these industries. We must continually devote significant engineering resources to achieving technical innovations and product developments. These developments are complex and require long development cycles. Moreover, we may have to make substantial investments in technological innovations and product developments before we can determine their commercial viability. We may lack sufficient financial resources to fund future development. Revenue from technological innovations, even if successfully developed, may not be sufficient to recoup the costs of development.

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. Our patent portfolio includes approximately 135 U.S. and foreign patents as well as approximately 240 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.

We typically work closely with our customers, who may also be potential competitors, and provide them with proprietary know-how. Although our 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 customers 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 be involved in legal action to enforce our intellectual property rights relating to our patents, copyrights or trade secrets. 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 hardware 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 or an injunction preventing us from conducting our business.

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 customers 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.

Current Economic Conditions, Including The Credit Crisis Affecting The Financial Markets And The Global Recession, Could Adversely Affect Our Business, Results Of Operations And Financial Condition

Over the past several years, the world's financial markets have been experiencing turmoil, characterized by reductions in available credit, increased costs of credit, volatility in security prices, rating downgrades of investments and reduced valuations of securities generally. These events have materially and adversely impacted the availability of financing to a wide variety of businesses, and the resulting uncertainty has led to reductions in capital investments, overall spending levels, future product plans, and sales projections across industries and markets. These trends could have a material adverse impact on our business, our ability to achieve targeted results of operations and our financial condition as a result of:

- reduced demand for our products or our customers' products that incorporate our technology;
- increased risk of order cancellations or delays;
- increased pressure on the prices for our products or our customers' products that incorporate our technology;
- greater difficulty in collecting accounts receivable; and
- risks to our liquidity, including the possibility that we might not have access to our cash when needed.

We are unable to predict the likely duration and severity of disruptions in financial markets and adverse economic conditions in the U.S. and other countries, but the longer the duration, the greater the risks we face in operating our business.

We Must Make Judgments in the Process of Preparing Our Financial Statements

We prepare our financial statements in accordance with generally accepted accounting principles and certain critical accounting policies 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.

If We are Unable to Maintain Effective Internal Controls Over Financial Reporting, Investors Could Lose Confidence In The Reliability of Our Financial Statements, Which Could Result In a Decline in the Price of Our Common Stock

As a public company, we are required to enhance and test our financial, internal and management control systems to meet obligations imposed by the Sarbanes-Oxley Act of 2002. Consistent with the Sarbanes-Oxley Act and the rules and regulations of the SEC, management's assessment of our internal controls over financial reporting and the audit opinion of our independent registered accounting firm as to the effectiveness of our controls is required in connection with our filing of our Annual Report on Form 10-K. If we are unable to identify, implement and conclude that we have effective internal controls over financial reporting or if our independent auditors are unable to conclude that our internal controls over financial reporting are effective, investors could lose confidence in the reliability of our financial statements, which could result in a decrease in the value of our common stock. Our assessment of our internal controls over financial reporting may also uncover weaknesses or other issues with these controls that could also result in adverse investor reaction.

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 customers;
- announcements of technological innovations or new products by us, our customers or our competitors;
- changes in DSL or biometrics market growth rates as well as investor perceptions regarding the investment opportunity that companies participating in the DSL or biometrics industry afford them;
- changes in earnings estimates by public market analysts;
- key personnel losses;
- sales of our common stock;
- our stock repurchase activities; 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.

LICENSING PRODUCT LINE RISKS

We Sold Substantially All of the Assets of Our DSL Silicon IP Licensing Product Line, And This Product Line Will No Longer Contribute Meaningful Contract Revenues

In November 2009, we sold substantially all of the assets associated with our DSL and home networking licensing product line to Lantiq for $6.75 million. Lantiq is a fabless semiconductor company that was spun out of Infineon. Prior to the spinout, Infineon was our largest DSL licensing customer. The sale included: i) our DSL and home networking technology products; ii) certain patents and patent applications related to these technologies; and iii) a group of 41 engineers and the equipment used by those engineers.

As a result of the sale, we will no longer license DSL silicon technology to semiconductor customers for the foreseeable future, nor will we derive DSL contract revenue from Infineon or Lantiq. In 2009, 2008, and 2007, we derived approximately 19%, 12% and 19% of our total revenue from Infineon/Lantiq, including contract revenue and royalties.

We Expect to Continue to Receive Royalty Revenues After the Sale to Lantiq; However Future Royalty Revenue May Decline Because of Factors That Are Beyond Our Control

Under the terms of our amended license with Lantiq, we expect to continue to receive royalties for DSL chipsets Lantiq sells. We also expect to continue to derive royalties and a minimal amount of contract revenue from Ikanos as our agreement with Ikanos remains in effect after the sale to Lantiq. Future royalties we may receive from Lantiq and Ikanos are influenced by factors that are beyond our control, including:

- The competitiveness of DSL chipsets offered by Lantiq and Ikanos and the willingness of their customers to purchase DSL chipsets from them;
- The promotional and marketing efforts of Lantiq and Ikanos; and
- DSL market risks in general, including: i) industry wide chipset demand; and ii) competitive pressures and cyclical demand for DSL chipsets, which may result in reduced average selling prices and channel inventory build-up.

Any or all of these factors may cause our royalty revenue to decline in the future.

Our Ability to Obtain, Sell, License, or Enforce Patents Could be Affected by New Laws, Regulations or Rules

We intend to continue to pursue the license, sale or enforcement of patents in our patent portfolio. Our patent portfolio includes approximately 135 U.S. and foreign patents as well as approximately 240 pending patent applications. We also have an active program to protect our proprietary technology through the filing of additional patents. New laws, regulations or rules implemented either by Congress, the United States Patent and Trademark Office, foreign patent offices, or the courts that impact the patent application process, the patent enforcement process or the rights of patent holders could significantly increase our expenses related to patent prosecution or decrease revenues associated with our patents. While we are not aware that any such changes are likely to occur in the foreseeable future, we cannot assure you that such changes will not occur.

BIOMETRICS PRODUCT LINE RISKS

Our Biometrics Product Line Faces Intense Competition

The markets for our biometrics products and services are competitive and uncertain. Many of our biometric software competitors have significantly greater financial, technological, marketing and personnel resources than we do. We also face intense competition from internal development teams within potential customers. We must convince potential customers to purchase products and services from us rather than develop software or perform services internally. Furthermore, customers, who have already purchased from us, may choose to stop purchasing our software and develop their own software.

In addition, announcements or introductions of new technologies or products by our competitors may adversely affect our business.

Biometrics Software Business Risks

Our biometrics software business is subject to a variety of additional risks, which could materially adversely affect our revenue and 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;
- 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 customers could fail to make payments under their current contracts;
- new laws, changes to existing laws, or regulatory developments; and
- general economic trends and other factors.

Biometrics Professional Services Business Risks

Our biometrics professional services business is subject to additional risks, which could materially adversely affect our revenue and operating results, including:

- our ability to structure and price technology contracts in a manner that is consistent with our business model;
- our ability to structure ourselves to successfully bid on U.S. government contracts and meet the requirements of U.S. contracting rules and regulations;
- our ability to deliver contract milestones: i) in a timely and cost efficient manner, and ii) in a form and condition acceptable to customers;
- the risk that customers could terminate projects;
- the risk that we rely substantially on third party contractors and consultants to deliver certain contract milestones; and

the potential that customers could fail to make payments under their contracts.

TEST & DIAGNOSTIC PRODUCT LINE RISKS

Our DSL Test and Diagnostics Business Depends Upon a Limited Number of Customers, Therefore We Derive Revenue from a Small Number of Customers

There are a relatively limited number of OEM suppliers and service providers to which we can sell our DSL test and diagnostics products in a manner consistent with our business model. While no single test and diagnostics customer represented more than 10% of our total revenue in 2008 and 2009, Spirent and Alcatel contributed significant revenue to our test and diagnostics business in those years.

If we fail to maintain relationships with our current customers or fail to establish a sufficient number of new customer relationships, our business could be seriously harmed. In addition, our current and prospective customers may use their superior size and bargaining power to demand terms that are unfavorable to us.

Our DSL Test and Diagnostics Business Faces Intense Competition

The markets for our DSL test and diagnostics hardware and software products are competitive and uncertain. Our success as a supplier of hardware and software products for DSL test and diagnostics depends in large part on:

- the willingness and ability of OEM customers to design, build and sell automated test heads, hand-held testers, and DSLAMs that incorporate or work with our products;
- our ability to market and sell to service providers; and
- our ability to provide effective sales, marketing, and customer service to our customers.

Our OEM customers, their competitors and service providers have significantly greater financial, technological, manufacturing, marketing and personnel resources than we do. We can give no assurance that our customers will continue to purchase products from us or that we will be able to compete effectively or that competitive pressures will not seriously harm our business.

The Success of Our DSL Test and Diagnostics Business Requires Telephone Companies to Install DSL Services in Volume

The success of our DSL test and diagnostics business depends upon telephone companies installing DSL services in significant volumes. Moreover, our business depends on capital equipment spending by telephone companies. If telephone companies reduce their budgets for or decide not to install or utilize equipment dedicated to DSL service or test infrastructure, our test and diagnostics business could be harmed.

DSL services offered over telephone networks also compete with alternative broadband services that use other broadband network architectures, such as cable networks, fiber-to-the-home networks, and wireless networks. These alternative broadband networks may be more successful than DSL. If telephone companies cannot compete effectively with alternative broadband services our test and diagnostics business could be harmed.

The Success of Our DSL Test and Diagnostics Products Depends On Our Ability to Develop Commercially Available Products in a Timely Fashion

Our success in developing and introducing, new and enhanced test and diagnostics products depends on the ability of our engineering organization to design and develop such products. Because of the complexity of our hardware and software products, it may take us a significant amount of time to develop commercially available products. If we cannot successfully develop and introduce new and enhanced test and diagnostics products on a timely basis, our DSL test and diagnostics business could be seriously harmed.

If Our Test and Diagnostics Hardware and Software Products Have Quality Problems, Our Business Could Be Harmed

If our test and diagnostics products have actual or perceived reliability, quality, functionality or other problems, we may suffer reduced orders, higher manufacturing costs, inability to recognize revenue, delays in collecting accounts receivable and higher service, support and warranty expenses or inventory write-offs, among other effects. We believe that the acceptance, volume production, timely delivery and customer satisfaction of our test and diagnostics products is important to our future financial results. As a result, any inability to correct any technical, reliability, parts shortages or other difficulties or to manufacture and ship our test and diagnostics products on a timely basis meeting customer requirements could damage our relationships and reputation with current and prospective customers, which would harm our revenues and operating results. Any product problems that may require repair or replacement may adversely affect our customer and/or vendor relationships and have an impact on support costs, warranty reserves, or inventory reserves, among other effects.

We are Dependent On a Single Source Contract Manufacturer for the Manufacture of Our DSL Hardware Products, the Loss of Which Would Harm Our Business

We currently depend on one contract manufacturer to manufacture our DSL hardware products. If this company was to terminate its arrangement with us or fail to provide the required capacity and quality on a timely basis, we would be unable to manufacture our products until replacement contract manufacturing services could be obtained. To qualify a new contract manufacturer, familiarize it with our products, quality standards and other requirements, and commence production is a costly and time-consuming process. We cannot assure you that we would be able to establish alternative manufacturing relationships on acceptable terms. Although we make reasonable efforts to ensure that our contract manufacturer performs to our standards, our reliance on a single source limits our control over quality assurance and delivery schedules. Defects in workmanship, inadequate yields, and manufacturing disruptions and difficulties may impair our ability to manage inventory and cause delays in shipments and cancellation of orders that may adversely affect our relationships with current and prospective customers. As a result, our test and diagnostics business could be harmed.

Our Manufacturing Systems May Not Be Adequate For Our DSL Test and Diagnostics Hardware Product Offerings

Our manufacturing systems have been adequate to manage current product configurations and production volumes. However, our manufacturing systems have not been tested by more complex hardware products or by production volumes higher than current levels. If our manufacturing systems are inadequate or have other problems, our test and diagnostics business could be harmed.

We are Dependent on Single Source Suppliers for Components in Our DSL Hardware Products

We rely on single source suppliers for components and materials used in our DSL hardware products. Our dependence on single source suppliers involves several risks, including limited control over pricing, availability, quality, and delivery schedules. Any delays in delivery of such components or shortages of such components could cause delays in the shipment of our products, which could significantly harm our business. Because of our reliance on these vendors, we may also be subject to increases in component costs. These increases could significantly harm our business.

If any one or more of our single source suppliers cease to provide us with sufficient quantities of our components in a timely manner or on terms acceptable to us, we would have to seek alternative sources of supply. We could incur delays while we locate and engage alternative qualified suppliers and we might be unable to engage alternative suppliers on favorable terms. We could incur substantial hardware and software redesign costs if we are required to replace the components. Any such disruption or increased expenses could harm our business.

ITEM 2:
Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
January 1, 2010 to January 31, 2010	60,659(1)	$2.66(1)	-	$-
February 1, 2010 to February 28, 2010	-	-	-	$-
March 1, 2010 to March 31, 2010	-	-	-	$-

(1) During January 2010, we accepted 60,659 shares of our common stock as a tax withholding from certain of our employees, in connection with the issuance of unrestricted stock awards that occurred during the period, at a share price of $2.66.

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: April 29, 2010	By:	/s/ Edmund C. Reiter Edmund C. Reiter, President & Chief Executive Officer
Date: April 29, 2010	By:	/s/ Richard P. Moberg Richard P. Moberg, Chief Financial Officer (Principal Financial and Accounting Officer)