

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, 1996

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.)

ONE OAK PARK, BEDFORD, MASSACHUSETTS, 01730  
-----

(Address of Principal Executive Offices)  
(Zip Code)

(617) 276-4000  
-----

(Registrant's Telephone Number, Including Area Code)

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

YES X NO  
--- ---

Indicate the number of shares outstanding of the issuer's common stock as of November 4, 1996:

CLASS -----	NUMBER OF SHARES OUTSTANDING -----
Common Stock, par value \$0.01 per share	18,905,397 shares

AWARE, INC.  
FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 1996

## PART I FINANCIAL INFORMATION

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

CONDENSED BALANCE SHEETS  
(UNAUDITED)

	SEPTEMBER 30, 1996	DECEMBER 31, 1995
	-----	-----
ASSETS		
Current assets:		
Cash and cash equivalents .....	\$ 31,483,407	\$ 2,153,681
Short-term investments .....	6,042,896	--
Accounts receivable (less allowance for doubtful accounts of \$15,300 in 1996 and \$5,300 in 1995) .....	1,025,779	500,828
Unbilled accounts receivable .....	193,273	116,261
Inventories .....	885,416	39,713
Prepaid expenses .....	81,366	14,471
	-----	-----
Total current assets .....	39,712,137	2,824,954
Property and equipment, net of accumulated depreciation and amortization of \$1,674,875 in 1996 and \$1,480,614 in 1995 .....	719,100	403,405
	-----	-----
Total assets .....	\$ 40,431,237	\$ 3,228,359
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable .....	\$ 574,417	\$ 111,519
Accrued expenses .....	144,317	65,404
Accrued compensation .....	159,358	67,887
Accrued professional fees .....	33,451	14,000
Deferred revenue .....	50,000	50,000
	-----	-----
Total current liabilities .....	961,543	308,810
Stockholders' equity:		
Preferred stock, \$1.00 par value; no shares authorized .....	--	--
Preferred stock, \$1.00 par value:		
Series B convertible preferred stock, 15,875 shares authorized, 15,875 issued and outstanding in 1995, none outstanding in 1996 .....	--	15,875
Series C convertible preferred stock, 13,525 shares authorized, 13,525 issued and outstanding in 1995, none outstanding in 1996 .....	--	13,525

Series D convertible preferred stock, 74,800 shares authorized, 69,166 issued and outstanding in 1995, none outstanding in 1996 .....	--	69,166
Series E convertible preferred stock, 45,000 shares authorized, 29,432 issued and outstanding in 1995, none outstanding in 1996 .....	--	29,432
Common stock, \$.01 par value; 30,000,000 shares authorized; issued and outstanding, 1,166,960 in 1995 and 18,905,397 in 1996 .....	189,054	11,670
Additional paid-in capital .....	49,957,203	13,807,945
Accumulated deficit .....	(10,223,601)	(10,575,102)
Treasury stock .....	(452,962)	(452,962)
	-----	-----
Total stockholders' equity .....	39,469,694	2,919,549
Total liabilities and stockholders' equity .....	\$ 40,431,237	\$ 3,228,359
	=====	=====

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

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AWARE, INC.

CONDENSED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	1996	1995	1996	1995
	-----	-----	-----	-----
Revenue:				
Product .....	\$ 379,926	\$ 99,720	\$ 529,945	\$ 324,521
License and royalty .....	782,047	349,729	2,221,652	742,240
Research and development .....	343,847	514,049	844,701	1,208,688
	-----	-----	-----	-----
Total revenue .....	1,505,820	963,498	3,596,298	2,275,449
Costs and expenses:				
Cost of product revenue .....	266,125	46,195	364,705	145,203
Cost of research and development revenue	215,256	259,195	607,843	864,585
Research and development .....	593,570	236,960	1,383,067	944,876
Selling and marketing .....	178,568	101,282	509,117	303,880
General and administrative .....	248,051	164,832	691,366	540,222
	-----	-----	-----	-----
Total costs and expenses .....	1,501,570	808,464	3,556,098	2,798,766
Income (loss) from operations .....	4,250	155,034	40,200	(523,317)
Interest income .....	257,433	24,931	311,301	85,787
	-----	-----	-----	-----
Net income (loss) .....	\$ 261,683	\$ 179,965	\$ 351,501	\$ (437,530)
	=====	=====	=====	=====
Net income (loss) per share .....	\$ 0.01	\$ 0.01	\$ 0.02	\$ (0.21)
	=====	=====	=====	=====
Weighted average common and common equivalent shares outstanding .....	19,071,834	15,077,312	17,544,989	2,043,593
	=====	=====	=====	=====

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

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AWARE, INC.

CONDENSED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

NINE MONTHS ENDED  
SEPTEMBER 30,

	1996	1995
Cash flows from operating activities:		
Net income (loss) .....	351,501	\$ (437,530)
Depreciation and amortization .....	194,720	150,282
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable .....	(524,951)	49,521
Unbilled accounts receivable .....	(77,012)	265,400
Inventories .....	(845,703)	(14,487)
Prepaid expenses .....	(66,895)	39,998
Accounts payable .....	462,898	(18,392)
Accrued expenses .....	189,835	(348,597)
Deferred revenue .....	--	(39,720)
Net cash used in operating activities .....	(315,607)	(353,525)
Cash flows from investing activities:		
Purchases of property and equipment .....	(510,415)	(186,550)
Net purchases of short-term investments .....	(6,042,896)	--
Net cash used in investing activities .....	(6,553,311)	(186,550)
Cash flows from financing activities:		
Proceeds from issuance of common stock .....	36,198,644	16,023
Increase (decrease) in cash and cash equivalents .....	29,329,726	(524,052)
Cash and cash equivalents, beginning of period .....	2,153,681	2,566,128
Cash and cash equivalents, end of period .....	\$31,483,407	\$2,042,076
	=====	=====
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest .....	\$ 820	\$ 668
SUPPLEMENTAL NONCASH DISCLOSURES:		
Conversion of preferred stock to common stock .....	\$ 127,998	--
Repurchase of Series D preferred shares for cancellation of notes .....	--	\$ 457,062

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

AWARE, INC.  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(UNAUDITED)

A) BASIS OF PRESENTATION

The accompanying unaudited condensed balance sheets, statements of operations, and statements of cash flows reflect all adjustments (consisting only of normal recurring items) which are, in the opinion of management, necessary for a fair presentation of financial position at September 30, 1996, and of operations and cash flows for the interim periods ended September 30, 1996 and 1995.

The accompanying unaudited condensed financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a complete presentation of operations, the financial position, and cash flows of the Company, in conformity with generally accepted accounting principles. The Company filed audited financial statements which included all information and footnotes necessary for such presentation for the years ended December 31, 1995 and December 31, 1994 in conjunction with a Registration Statement on Form S-1 (SEC File No. 333-6807), as declared effective on August 8, 1996.

The results of operations for the interim period ended September 30, 1996 are not necessarily indicative of the results to be expected for the year.

B) INVENTORY

Inventory consists primarily of the following:

	SEPTEMBER 30, 1996	DECEMBER 31, 1995
	-----	-----
Raw materials .....	\$516,516	\$39,713
Finished goods .....	368,900	--
	-----	-----
Total .....	\$885,416	\$39,713
	=====	=====

C) NET INCOME (LOSS) PER SHARE

Net income (loss) per share is based on the weighted average number of common and dilutive common equivalent shares (common stock options and convertible preferred stock) outstanding. Common equivalent shares are not included in the per share calculations for the nine months ended September 30, 1995, because the effect of their inclusion would be antidilutive, except in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 83. The Bulletin requires all common shares issued and options to purchase shares of common stock granted by the Company during the twelve-month period prior to the filing of a proposed initial public offering to be included in the calculation as if they were outstanding for all periods.

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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

The statements contained in the following Management's Discussion and Analysis of Financial Condition and Results of Operations which are not historical are "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent the Company's present expectations or beliefs concerning future events, however the Company cautions that such statements are qualified by important factors. Such factors, which are identified under the heading "Risk Factors" below, could cause actual results to differ materially from those indicated in Management's Discussion and Analysis of Financial Condition and Results of Operations.

RESULTS OF OPERATIONS

Product Revenue. Product revenue consists primarily of revenue from the sale of tangible products, such as Asymmetric Digital Subscriber Line ("ADSL") modems and video editing chipset products, which are manufactured by the Company or third party suppliers. Product revenue increased by 281% from \$99,720 in the third quarter of 1995 to \$379,926 in the current year quarter. Product revenue as a percentage of total revenue was 25% in the third quarter of 1996 as compared to 10% in the corresponding quarter of 1995. The dollar increase, as well as the increase as a percentage of total revenue, is primarily due to the following reasons. Revenue in the third quarter of 1995 consisted primarily of revenue from the sale of video editing chipset products, which the Company discontinued in the fourth quarter of 1995. Revenue in the third quarter of 1996 consisted primarily of revenue from the sale of ADSL modems, which the Company began shipping in the first quarter of 1996. Accordingly, a comparison of product revenue on a year over year basis is not particularly meaningful due to differences in the composition of product revenue.

For the nine months ended September 30, product revenue increased by 63% from \$324,521 in 1995 to \$529,945 in 1996. Product revenue as a percentage of total revenue was 15% for the first nine months of 1996 as compared to 14% in

the corresponding period in 1995. A comparison of product revenue on a nine month period over period basis is not particularly meaningful due to differences in the composition of product revenue.

License and Royalty Revenue. License and royalty revenue consists primarily of revenue from the sale of intellectual property, such as hardware and software technology licenses, compression software licenses, and royalties from the sale of chipsets by customers who have licensed the Company's technology. As such revenue has only a nominal cost of sale associated with it, the Company does not report a separate cost of license and royalty revenue line in its Statements of Operations.

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License and royalty revenue increased by 124% from \$349,729 in the third quarter of 1995 to \$782,047 in the current year quarter. License and royalty revenue as a percentage of total revenue was 52% in the third quarter of 1996 as compared to 36% in the corresponding quarter of 1995. For the nine months ended September 30, license and royalty revenue increased by 199% from \$742,240 in 1995 to \$2,221,652 in 1996. License and royalty revenue as a percentage of total revenue was 62% for the first nine months of 1996 as compared to 33% in the corresponding period of 1995. The dollar increase as well as the increase as a percentage of total revenue, in both the three and nine month periods, is primarily due to an increase in the sale of ADSL and other broadband technology licenses to telephone company equipment suppliers, and sales of compression software licenses.

Research and Development Revenue. Research and development revenue consists primarily of revenue from commercial contract engineering and development, and government research contracts. Research and development revenue decreased by 33% from \$514,049 in the third quarter of 1995 to \$343,847 in the current year quarter. Research and development revenue as a percentage of total revenue was 23% in the third quarter of 1996 as compared to 53% in the corresponding quarter of 1995. The dollar decrease is primarily due to lower revenue from commercial research and development contracts, as well as lower revenue from U.S. government research contracts.

For the nine months ended September 30, research and development revenue decreased by 30% from \$1,208,688 in 1995 to \$844,701 in 1996. Research and development revenue as a percentage of total revenue was 24% for the first nine months of 1996 as compared to 53% in the corresponding period of 1995. The dollar decrease is primarily due to lower revenue from commercial research and development contracts.

For both the three and nine month periods, the decrease in research and development revenue as a percentage of total revenue was driven by the Company's decision to shift its business away from contract research activities toward the sale of commercial technology licenses, which resulted in lower research and development revenue and higher product and license and royalty revenue.

Cost of Product Revenue. Cost of product revenue consists primarily of direct material, direct labor and overhead costs to produce the Company's products, and cost of goods for purchases of finished goods inventory from third party suppliers. Cost of product revenue as a percentage of product revenue was 70% in the third quarter of 1996 as compared to 46% in the prior year quarter. Cost of product revenue as a percentage of product revenue was 69% for the first nine months of 1996 as compared to 45% in the corresponding 1995 period. In the three and nine month periods in 1996, the percentages primarily reflect the cost of modem revenue. In the three and nine month periods in 1995, the percentages primarily reflect the cost of video editing chipset revenue. Accordingly, a comparison of cost of product revenue on a year over year basis is not particularly meaningful due to differences in the composition of product revenue.

Cost of Research and Development Revenue. Cost of research and development revenue consists primarily of direct labor, direct material and travel expenses associated with commercial contract engineering and development, and government research contracts. As a percentage of research and development revenue, related costs increased from 50% in the third quarter of 1995 to 63% in the current year quarter. The increase in cost as a percentage of research and

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development revenue is primarily attributable to the mix of commercial and U.S. government research contracts, and the profitability of individual contracts. The cost of research and development revenue as a percentage of research and development revenue was unchanged at 72% for the nine month periods in 1995 and 1996.

**Research and Development Expense.** Research and development expense consists primarily of employee and consultant costs, supplies and allocated facilities costs related to the development and enhancement of the Company's products and technology. Research and development expense increased by 151% from \$236,960 in the third quarter of 1995 to \$593,570 in the current year quarter. For the nine month period ended September 30, research and development expense increased 46% from \$944,876 in 1995 to \$1,383,067 in 1996. For the three and nine month periods, the increase in research and development expense is primarily attributable to higher spending on projects to develop, enhance, and commercialize the Company's ADSL and Hybrid Fiber Coaxial technology. Higher spending on these projects was partially offset by lower spending as a result of the discontinuance of research involving audio compression technology and lower facilities costs as a result of the relocation of the Company's facilities in June 1995.

**Selling and Marketing Expense.** Selling and marketing expense consists primarily of salaries for sales and marketing personnel, travel, product advertising, and allocated facilities expense. Selling and marketing expense increased 76% from \$101,282 in the third quarter of 1995 to \$178,568 in the current year quarter. For the nine month period ended September 30, sales and marketing expense increased 68% from \$303,880 in 1995 to \$509,117 in 1996. For the three and nine month periods, the increase is primarily due to the addition of sales personnel and increased product advertising related to the introduction of the Company's ADSL modem.

**General and Administrative Expense.** General and administrative expense consists primarily of salaries for administrative officers and support personnel, allocated facilities costs, and professional services, such as legal and audit expenses. General and administrative expense increased by 51% from \$164,832 in the third quarter of 1995 to \$248,051 in the current year quarter. For the nine month period ended September 30, general and administrative expense increased 28% from \$540,222 in 1995 to \$691,366 in 1996. For the three and nine month periods, the increase is primarily due to additions to the Company's management team, legal expenses, and, with respect to the three month period, expenses associated with becoming a public company.

**Interest Income.** Interest income increased from \$24,931 in the third quarter of 1995 to \$257,433 in the current year quarter, primarily as a result of higher cash balances due to the investment of net proceeds from the Company's initial public offering ("IPO"). For the nine months ended September 30, interest income increased from \$85,787 in 1995 to \$311,301 in 1996, also primarily as a result interest earned on the IPO proceeds.

**Income Taxes.** The Company has not provided for income taxes as it has a history of net losses, which has resulted in tax loss carryforwards. As of December 31, 1995, the Company had net operating loss carryforwards of approximately \$9,700,000 and approximately \$576,000 of research and development tax credit carryforwards to offset future federal taxable income. To the extent not utilized, the net operating loss and tax credit carryforwards expire between 2003 and 2010.

#### LIQUIDITY AND CAPITAL RESOURCES

Cash, cash equivalents and short-term investments increased by \$35,372,622 to \$37,526,303 at September 30, 1996. The primary source of cash flow in the first nine months of 1996 was approximately \$36,199,000 of net proceeds from the issuance of common stock. In the third quarter of 1996, the Company completed an initial public offering of its common stock. The Company sold 3,910,000 shares and realized net proceeds of approximately \$35,162,000. The Company also realized approximately \$1,000,000 of proceeds from the issuance of common stock in connection with its stock option plans. Net proceeds from the sale of common stock were offset by \$315,607 of cash used in operations, and \$510,415 of cash

invested in property and equipment.

Funds used in operations were principally attributable to an increase in inventory. The Company purchased raw materials to manufacture ADSL modems in anticipation of increased sales from such products. The increase in property and equipment was primarily related to purchases of computer and other equipment used in research and development activities.

While there can be no assurance that the Company will not require additional financing, or that such financing will be available to the Company, the Company believes that its financial resources are adequate to meet its liquidity requirements over the next twelve months.

#### RISK FACTORS

The Company believes that the occurrence of any one or some combination of the following risk factors could have a material adverse effect on the Company's business, financial condition and results of operations.

##### History of Operating Losses

The Company has incurred net losses in every fiscal year since inception. Substantial additional research and development expenses to enhance the performance and reduce the manufacturing costs of the Company's products will be required before market acceptance can be determined. There can be no assurance that the Company will achieve profitable operations in any future period.

##### Dependence on Acceptance of ADSL Technology

The Company's future success is substantially dependent upon whether ADSL technology gains widespread commercial acceptance by the telephone companies ("telcos") and end users of telco services. The Company has invested substantial resources in the development of ADSL technology implemented through the Discrete Multi-Tone ("DMT") modulation technique. Telcos have only begun evaluating DMT-based ADSL technology, and there can be no assurance that the telcos will pursue the deployment of such ADSL technology.

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##### Reliance on Telcos; Dependence on a Limited Number of Customers

Even if telcos adopt policies favoring full-scale implementation of ADSL technology, there can be no assurance that sales of the Company's ADSL products will become significant. The Company's customers, including Regional Bell Operating Companies ("RBOCs"), OEMs and other telcos, are relatively few in number and have significantly greater resources than that of the Company. The Company has limited ability to influence or control decisions made by these customers. There can be no assurance that these customers will not use their size and bargaining power to demand unfavorable terms and conditions (including price), seek alternative suppliers, or undertake internal development of products comparable to those of the Company's.

##### Substantial Dependence on Analog Devices, Inc.

The Company and Analog Devices, Inc. ("ADI") have entered into a series of agreements to develop integrated chipsets based on the Company's technology. The inability or refusal of ADI to manufacture, market and sell such chipsets in substantial quantities would prevent telcos from adopting the Company's technology and would have a material adverse effect on the Company's business. There can be no assurance that ADI will succeed or, in the event that ADI is not successful, that the Company would be able to find a substitute chipset manufacturer without significant delays.

##### Proprietary Technology; Risk of Third Party Claims of Infringement

The Company's ability to compete effectively will depend to a significant extent on its ability to protect its proprietary information and to operate without infringing the intellectual property rights of others. Despite the precautions the Company has taken to protect its intellectual property, there can be no assurance that such steps will be adequate to prevent the misappropriation of its technology. In addition, third parties may assert exclusive patent, copyright and other intellectual property rights to



technologies that are important to the Company. There can be no assurance that other third parties will not assert such claims against the Company in the future.

#### Rapid Technological Change; Dependence on New Products

The markets for the Company's products are characterized by rapid technological advances, evolving industry standards, changes in end-user requirements, frequent new product introductions, and evolving telco offerings. The Company's business will be materially adversely affected if technologies or standards on which Company's products are based become obsolete, or if the Company is unable to develop and introduce new products in a timely manner in response to changing market conditions.

#### Competition

The markets for the Company's products are intensely competitive and the Company expects competition to increase in the immediate future. Many of the Company's competitors and potential competitors, including the RBOCs and AT&T Paradyne Corporation, have significantly greater financial, technological, manufacturing, marketing and personnel resources than the Company. There can be no assurance that the Company will be able to compete successfully or that competition will not adversely affect the Company's business.

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#### 12 Manufacturing

The Company has limited experience in manufacturing or in supervising the manufacture of its products, including its ADSL Internet Access Modem. There can be no assurance that the Company will not encounter significant difficulties in manufacturing or controlling the quality of its products, or that its products will be reliable in the field.

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#### PART II. OTHER INFORMATION ITEM 6: EXHIBITS AND REPORTS ON FORM 8-K

##### (A) EXHIBITS

Exhibit 11.1\* - Computation of Net Income (Loss) per Share

##### (B) REPORTS ON 8-K

None.

- - - - -

\*filed herewith

#### 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.

Date: November 8, 1996

AWARE, INC.

By: /s/ James C. Bender

-----  
James C. Bender, Chief  
Executive Officer and President

Date: November 8, 1996

/s/ Richard P. Moberg

-----  
Richard P. Moberg, Vice President  
and Chief Financial Officer  
(Principal Financial and Accounting  
Officer)

AWARE, INC.

COMPUTATION OF PRIMARY AND FULLY DILUTED  
NET INCOME (LOSS) PER SHARE

	THREE MONTHS ENDED	
	SEPTEMBER 30,	
	1996	1995
Net income .....	\$ 261,683	\$ 179,965
Weighted average number of common and common stock equivalent shares outstanding:		
Common stock .....	15,014,883	1,166,927
Convertible preferred common stock equivalents .....	2,058,232	12,799,775
Option common stock equivalent shares .....	1,998,719	228,321
Effect of SAB 83 .....	--	882,289
Common and common stock equivalent shares outstanding for purpose of calculating primary net income per share ..	19,071,834	15,077,312
Incremental shares to reflect full dilution .....	335,411	--
Total shares for purpose of calculating fully diluted net income per share .....	19,407,245	15,077,312
Primary net income per share .....	\$ 0.01	\$ 0.01
Fully diluted net income per share .....	\$ 0.01	\$ 0.01
	NINE MONTHS ENDED	
	SEPTEMBER 30,	
	1996	1995
Net income (loss) .....	\$ 351,501	\$ (437,530)
Weighted average number of common and common stock equivalent shares outstanding:		
Common stock .....	8,145,160	1,161,304
Convertible preferred common stock equivalents .....	7,289,474	--
Option common stock equivalent shares .....	1,710,345	--
Effect of SAB 83 .....	400,010	882,289
Common and common stock equivalent shares outstanding for purpose of calculating		
primary net income (loss) per		
share .....	17,544,989	2,043,593
Incremental shares to reflect full dilution .....	614,609	--
Total shares for purpose of calculating fully diluted net income (loss) per share .....	18,159,598	2,043,593
Primary net income (loss) per share .....	\$ 0.02	\$ (0.21)
Fully diluted net income (loss) per share .....	\$ 0.02	\$ (0.21)

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