
**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, 2018

Commission file number 000-21129

AWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Massachusetts
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).
YES NO

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

Large Accelerated Filer
Non-Accelerated Filer
Emerging Growth Company

Accelerated Filer
Smaller Reporting Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

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

Indicate the number of shares outstanding of the issuer's common stock as of October 22, 2018:

<u>Class</u>	<u>Number of Shares Outstanding</u>
Common Stock, par value \$0.01 per share	21,545,113 shares

AWARE, INC.
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2018

TABLE OF CONTENTS

	<u>Page</u>
PART I	FINANCIAL INFORMATION
<u>Item 1.</u>	<u>Unaudited Consolidated Financial Statements</u>
	<u>Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u> 3
	<u>Consolidated Statements of Income and Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and September 30, 2017</u> 4
	<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and September 30, 2017</u> 5
	<u>Notes to Consolidated Financial Statements</u> 6
<u>Item 2.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> 18
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u> 25
<u>Item 4.</u>	<u>Controls and Procedures</u> 25
PART II	OTHER INFORMATION
<u>Item 1.</u>	<u>Legal Proceedings</u> 26
<u>Item 1A.</u>	<u>Risk Factors</u> 26
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 26
<u>Item 4.</u>	<u>Mine Safety Disclosures</u> 26
<u>Item 6.</u>	<u>Exhibits</u> 27
	<u>Signatures</u> 27

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

	September 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 48,963	\$ 51,608
Accounts receivable, net	5,359	2,389
Unbilled receivables	2,155	1,429
Prepaid expenses and other current assets	386	216
Total current assets	<u>56,863</u>	<u>55,642</u>
Property and equipment, net	4,128	4,304
Deferred tax assets	5,199	5,071
Other assets	-	18
Total assets	<u>\$ 66,190</u>	<u>\$ 65,035</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 160	\$ 166
Accrued expenses	1,685	1,401
Accrued income taxes	48	2
Deferred revenue	3,038	2,805
Total current liabilities	<u>4,931</u>	<u>4,374</u>
Long-term deferred revenue	<u>77</u>	<u>127</u>
Commitments and contingent liabilities		
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 21,545,113 as of September 30, 2018 and 21,493,440 as of December 31, 2017	215	215
Additional paid-in capital	96,299	96,246
Accumulated deficit	(35,332)	(35,927)
Total stockholders' equity	<u>61,182</u>	<u>60,534</u>
Total liabilities and stockholders' equity	<u>\$ 66,190</u>	<u>\$ 65,035</u>

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenue:				
Software licenses	\$ 3,449	\$ 4,233	\$ 6,582	\$ 7,732
Software maintenance	1,297	1,088	3,993	3,622
Services	655	343	1,498	924
Royalties	-	43	-	127
Total revenue	<u>5,401</u>	<u>5,707</u>	<u>12,073</u>	<u>12,405</u>
Costs and expenses:				
Cost of software licenses	20	27	20	274
Cost of services	320	179	740	499
Research and development	1,816	2,151	5,579	5,884
Selling and marketing	1,297	1,028	3,234	2,938
General and administrative	807	849	2,463	2,454
Total costs and expenses	<u>4,260</u>	<u>4,234</u>	<u>12,036</u>	<u>12,049</u>
Patent related income	<u>1</u>	<u>19</u>	<u>1</u>	<u>1,422</u>
Operating income	1,142	1,492	38	1,778
Other income	-	-	-	36
Interest income	224	109	587	281
Income before provision for income taxes	<u>1,366</u>	<u>1,601</u>	<u>625</u>	<u>2,095</u>
Provision for income taxes	89	456	31	535
Net income	<u>\$ 1,277</u>	<u>\$ 1,145</u>	<u>\$ 594</u>	<u>\$ 1,560</u>
Net income per share – basic	\$ 0.06	\$ 0.05	\$ 0.03	\$ 0.07
Net income per share – diluted	\$ 0.06	\$ 0.05	\$ 0.03	\$ 0.07
Weighted-average shares – basic	21,564	21,679	21,548	21,900
Weighted-average shares - diluted	21,639	21,758	21,604	21,967
Comprehensive income:				
Net income	\$ 1,277	\$ 1,145	\$ 594	\$ 1,560
Other comprehensive income (net of tax):				
Unrealized gains on available for sale securities	-	-	-	19
Comprehensive income	<u>\$ 1,277</u>	<u>\$ 1,145</u>	<u>\$ 594</u>	<u>\$ 1,541</u>

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

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

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 594	\$ 1,560
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	336	390
Stock-based compensation	394	465
Deferred tax benefit on other comprehensive income	-	(9)
Amortization of discount on investments	-	(4)
Gain on sale of investments	-	(36)
Changes in assets and liabilities:		
Accounts receivable	(2,970)	(2,626)
Unbilled receivables	(726)	617
Prepaid expenses and other current assets	(170)	(39)
Deferred tax assets	(128)	(20)
Accounts payable	(6)	397
Accrued expenses	284	108
Accrued income taxes	46	12
Deferred revenue	183	(204)
Net cash provided by (used in) operating activities	<u>(2,163)</u>	<u>611</u>
Cash flows from investing activities:		
Purchases of property and equipment	(142)	(61)
Sales of investments	-	1,019
Net cash provided by (used in) investing activities	<u>(142)</u>	<u>958</u>
Cash flows from financing activities:		
Proceeds from issuance of common stock	27	42
Payments made for taxes of employees who surrendered shares related to unrestricted stock	(107)	(186)
Repurchase of common stock	(260)	(4,213)
Net cash used in financing activities	<u>(340)</u>	<u>(4,357)</u>
Decrease in cash and cash equivalents	(2,645)	(2,788)
Cash and cash equivalents, beginning of period	51,608	51,913
Cash and cash equivalents, end of period	<u>\$ 48,963</u>	<u>\$ 49,125</u>
Supplemental disclosure:		
Cash paid for income taxes	<u>\$ 94</u>	<u>\$ 473</u>

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

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

- A) **Nature of Business.** We are a leading provider of software and services to the biometrics industry. Our software products are used in government and commercial biometrics systems, which are capable of determining or verifying an individual's identity. We also offer engineering services related to software customization, integration, and installation, as well as complete systems development. We sell our biometrics software products and services globally through systems integrators, OEMs, and directly to end user customers. We also derive a portion of our revenue from the sale of imaging software.
- B) **Basis of Presentation.** The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and notes necessary for a complete presentation of our financial position, results of operations and cash flows, in conformity with generally accepted accounting principles. We filed audited financial statements which included all information and notes necessary for such presentation for the three years ended December 31, 2017 in conjunction with our 2017 Annual Report on Form 10-K. This Form 10-Q should be read in conjunction with that Form 10-K.

The accompanying unaudited consolidated balance sheets, consolidated statements of income and comprehensive income, and statements of cash flows reflect all adjustments (consisting only of normal recurring items) which are, in the opinion of management, necessary for a fair presentation of financial position at September 30, 2018, and of operations and cash flows for the interim periods ended September 30, 2018 and 2017.

The results of operations for the interim period ended September 30, 2018 are not necessarily indicative of the results to be expected for the year.

- C) **Revenue Recognition.** Effective January 1, 2018, we adopted Accounting Standards Codification ("ASC"), Topic 606, Revenue from Contracts with Customers ("ASC 606"), using the full retrospective transition method. Adoption of the standard using the full retrospective method required us to restate certain previously reported results.

In accordance with ASC 606, revenue is recognized when a customer obtains control of promised goods and services. The amount of revenue recognized reflects the consideration to which we expect to be entitled to receive in exchange for these goods and services. In addition, ASC 606 requires disclosures of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The core principle of the standard is that we should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which we expect to be entitled in exchange for those goods or services. To achieve that core principle, we should apply the following five step model:

1. Identify the contract with the customer;
2. Identify the performance obligations in the contract;
3. Determine the transaction price;
4. Allocate the transaction price to the performance obligations in the contract; and
5. Recognize revenue when (or as) each performance obligation is satisfied.

1) Identify the contract with the customer

A contract with a customer exists when (i) we enter into an enforceable contract with a customer that defines each party's rights regarding the goods or services to be transferred and identifies the related payment terms, (ii) the contract has commercial substance, and (iii) we determine that collection of substantially all consideration for goods and services that are transferred is probable based on the customer's intent and ability to pay the promised consideration. We apply judgment in determining the customer's intent and ability to pay, which is based on a variety of factors including the customer's historical payment experience, or in the case of a new customer, published credit and financial information pertaining to the customer.

We evaluate contract modifications for the impact on revenue recognition if they have been approved by both parties such that the enforceable rights and obligations under the contract have changed. Contract modifications are either accounted for using a cumulative effect adjustment or prospectively over the remaining term of the arrangement. The determination of which method is more appropriate depends on the nature of the modification, which we evaluate on a case-by-case basis.

We combine two or more contracts entered into at or near the same time with the same customer and account for them as a single contract if (i) the contracts are negotiated as a package with a common commercial objective, (ii) the amount of consideration to be paid in one contract depends on the price or performance of the other contract, or (iii) some or all of the goods or services in one contract would be combined with some or all of the goods and services in the other contract into a single performance obligation. If two or more contracts are combined, the consideration to be paid is aggregated and allocated to the individual performance obligations without regard to the consideration specified in the individual contracts.

2) Identify the performance obligations in the contract

Performance obligations promised in a contract are identified based on the goods and services that will be transferred to the customer that are both capable of being distinct, whereby the customer can benefit from the good or service either on its own or together with other available resources, and are distinct in the context of the contract, whereby the transfer of the good or service is separately identifiable from other promises in the contract. To the extent a contract includes multiple promised goods and services, we apply judgment to determine whether promised goods and services are capable of being distinct and distinct in the context of the contract. If these criteria are not met, the promised goods and services are accounted for as a combined performance obligation. To identify performance obligations, we consider all of the goods or services promised in a contract regardless of whether they are explicitly stated or are implied by customary business practices.

3) Determine the transaction price

The transaction price is determined based on the consideration we expect to be entitled in exchange for transferring promised goods and services to the customer. Determining the transaction price requires significant judgment. To the extent the transaction price includes variable consideration, we estimate the amount of variable consideration that should be included in the transaction price utilizing either the expected value method or the most likely amount method depending on the nature of the variable consideration. Variable consideration is included in the transaction price if, in our judgment, it is probable that a significant future reversal of cumulative revenue recognized under the contract will not occur. Any estimates, including the effect of the constraint on variable consideration, are evaluated at each reporting period. The amount of consideration is not adjusted for a significant financing component if the time between payment and the transfer of the related good or service is expected to be one year or less under the practical expedient in ASC 606-10-32-18. Our revenue arrangements are typically accounted for under such expedient, as payment is typically due within 30 to 60 days. As of September 30, 2018, none of our contracts contained a significant financing component.

4) Allocate the transaction price to performance obligations in the contract

If the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price ("SSP") basis unless the transaction price is variable and meets the criteria to be allocated entirely to a performance obligation or to a distinct service that forms part of a single performance obligation. The consideration to be received is allocated among the separate performance obligations based on relative SSPs. The SSP is the price at which we would sell a promised good or service separately to a customer. The best estimate of SSP is the observable price of a good or service when we sell that good or service separately. A contractually stated price or a list price for a good or service may be the SSP of that good or service. We use a range of amounts to estimate SSP when we sell each of the goods and services separately and need to determine whether there is a discount that needs to be allocated based on the relative SSP of the various goods and services. In instances where SSP is not directly observable, such as when we do not sell the product or service separately, we typically determine the SSP using an adjusted market assessment approach using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual goods and services due to the stratification of those goods and services by customers and circumstances. In these instances, we may use information such as the nature of the customer and distribution channel in determining the SSP.

5) Recognize revenue when or as we satisfy a performance obligation

We satisfy performance obligations either over time or at a point in time as discussed in further detail below. Revenue is recognized over time if 1) the customer simultaneously receives and consumes the benefits provided by our performance, 2) our performance creates or enhances an asset that the customer controls as the asset is created or enhanced, or 3) our performance does not create an asset with an alternative use to us and we have an enforceable right to payment for performance completed to date. If we do not satisfy a performance obligation over time, the related performance obligation is satisfied at a point in time by transferring the control of a promised good or service to a customer.

We categorize revenue as software licenses, software maintenance, services, or royalties. In addition to the general revenue recognition policies described above, specific revenue recognition policies apply to each category of revenue.

Software licenses

Software licenses consist of revenue from the sale of software licenses for biometrics and imaging applications. Our software licenses are functional intellectual property and typically provide customers with the right to use our software in perpetuity as it exists when made available to the customer. We recognize revenue from software licenses at a point in time upon delivery, provided all other revenue recognition criteria are met.

Software maintenance

Software maintenance consists of revenue from the sale of software maintenance contracts for biometrics and imaging software. Software maintenance contracts entitle customers to receive software support and software updates, if and when they become available, during the term of the maintenance contract. Software support and software updates are considered distinct services. However, these distinct services are considered a single performance obligation consisting of a series of distinct services that are substantially the same and have the same pattern of transfer to the customer. We recognize software maintenance revenue over time on a straight-line basis over the contract period.

Services

Service revenue consists of fees from biometrics customers for software engineering services we provide to them. We recognize services revenue over time as the services are delivered using an input method (i.e., labor hours incurred as a percentage of total labor hours budgeted), provided all other revenue recognition criteria are met.

Royalties

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

We recognize revenue from sales-based royalties at the later of (i) when the related sales occur, or (ii) when the performance obligation to which some or all of the royalty has been allocated has been satisfied (or partially satisfied).

Refer to Note G – Business Segments for further information on the disaggregation of revenue, including revenue by geography and category.

Arrangements with multiple performance obligations

In addition to selling software licenses, software maintenance and software services on a standalone basis, a significant portion of our contracts include multiple performance obligations. The various combinations of multiple performance obligations and our revenue recognition for each are described as follows:

- Software licenses and software maintenance. When software licenses and software maintenance contracts are sold together, the software licenses and software maintenance are generally considered distinct performance obligations. The transaction price is allocated to the software licenses and the software maintenance based on relative SSP. Revenue allocated to the software licenses is recognized at a point in time upon delivery, provided all other revenue recognition criteria are met. Revenue allocated to the software maintenance is recognized over time on a straight-line basis over the contract period.
- Software licenses and services. When software licenses and significant customization engineering services are sold together, they are accounted for as a combined performance obligation, as the software licenses are generally highly dependent on, and interrelated with, the associated services and therefore are not distinct performance obligations. Revenue for the combined performance obligation is recognized over time as the services are delivered using an input method (i.e., labor hours incurred as a percentage of total labor hours budgeted). When software licenses and standard implementation or consulting-type services are sold together, they are generally considered distinct performance obligations, as the software licenses are not dependent on or interrelated with the associated services. The transaction price in these arrangements is allocated to the software licenses and services based on relative SSP. Revenue allocated to the software licenses is recognized at a point in time upon delivery, provided all other revenue recognition criteria are met. Revenue allocated to the services is recognized over time using an input method (i.e., labor hours incurred as a percentage of total labor hours budgeted). In arrangements with both software licenses and services, the software license portion of the arrangement is classified as software license revenue and the services portion is classified as services revenue in our consolidated statements of income and comprehensive income.
- Software licenses, software maintenance and services. When we sell software licenses, software maintenance and software services together, we account for the individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations based on relative SSP. Revenue allocated to the software licenses is recognized at a point in time upon delivery. Revenue allocated to the services is recognized over time using an input method (i.e., labor hours incurred as a percentage of total labor hours budgeted). Revenue for the software maintenance is recognized over time on a straight-line basis over the contract period. However, if the software services are significant customization engineering services, they are accounted for with the software licenses as a combined performance obligation, as stated above. Revenue for the combined performance obligation is recognized over time using an input method (i.e., labor hours incurred as a percentage of total labor hours budgeted).

Returns

We do not offer rights of return for our products and services in the normal course of business.

Customer Acceptance

Our contracts with customers generally do not include customer acceptance clauses.

Contract Balances

When the timing of our delivery of goods or services is different from the timing of payments made by customers, we recognize either a contract asset (performance precedes contractual due date) or a contract liability (customer payment precedes performance). Customers that prepay are represented by the deferred revenue below until the performance obligation is satisfied. Contract assets represent arrangements in which the good or service has been delivered but payment is not yet due. Our contract assets consist of unbilled receivables. Our contract liabilities consisted of deferred (unearned) revenue, which is generally related to software maintenance contracts. We classify deferred revenue as current or noncurrent based on the timing of when we expect to recognize revenue.

The following table presents changes in our contract assets and liabilities during the three and nine months ended September 30, 2017 and 2018 (in thousands):

	<u>Balance at Beginning of Period</u>	<u>Revenue Recognized In Advance of Billings</u>	<u>Billings</u>	<u>Balance at End of Period</u>
Three months ended September 30, 2017				
Contract assets:				
Unbilled receivables	\$ 1,883	\$ 43	\$ (283)	\$ 1,643
Three months ended September 30, 2018				
Contract assets:				
Unbilled receivables	\$ 1,542	\$ 1,170	\$ (557)	\$ 2,155
	<u>Balance at Beginning of Period</u>	<u>Billings</u>	<u>Revenue Recognized</u>	<u>Balance at End of Period</u>
Three months ended September 30, 2017				
Contract liabilities:				
Deferred revenue	\$ 2,291	\$ 1,527	\$ (1,089)	\$ 2,729
Three months ended September 30, 2018				
Contract liabilities:				
Deferred revenue	\$ 2,421	\$ 1,991	\$ (1,297)	\$ 3,115
	<u>Balance at Beginning of Period</u>	<u>Revenue Recognized In Advance of Billings</u>	<u>Billings</u>	<u>Balance at End of Period</u>
Nine months ended September 30, 2017				
Contract assets:				
Unbilled receivables	\$ 2,259	\$ 169	\$ (785)	\$ 1,643
Nine months ended September 30, 2018				
Contract assets:				
Unbilled receivables	\$ 1,429	\$ 1,745	\$ (1,019)	\$ 2,155
	<u>Balance at Beginning of Period</u>	<u>Billings</u>	<u>Revenue Recognized</u>	<u>Balance at End of Period</u>
Nine months ended September 30, 2017				
Contract liabilities:				
Deferred revenue	\$ 2,933	\$ 3,430	\$ (3,634)	\$ 2,729
Nine months ended September 30, 2018				
Contract liabilities:				
Deferred revenue	\$ 2,932	\$ 4,176	\$ (3,993)	\$ 3,115

Remaining Performance Obligations

Remaining performance obligations represent the transaction price from contracts for which work has not been performed or goods and services have not been delivered. We expect to recognize revenue on approximately 98% of the remaining performance obligations over the next 12 months, with the remainder recognized thereafter. As of September 30, 2018, the aggregate amount of the transaction price allocated to remaining performance obligations for software maintenance contracts with a duration greater than one year was \$0.1 million. This does not include revenue related to performance obligations that are part of a contract whose original expected duration is one year or less.

Contract Costs

We recognize an other asset for the incremental costs of obtaining a contract with a customer if we expect the benefit of those costs to be longer than one year. We have determined that certain sales commissions meet the requirements to be capitalized, and we amortize these costs on a consistent basis with the pattern of transfer of the goods and services in the contract. Total capitalized costs to obtain a contract were immaterial during the periods presented and are included in other current and long-term assets on our consolidated balance sheets.

We apply a practical expedient to expense costs as incurred for costs to obtain a contract when the amortization period is one year or less. These costs include sales commissions on software maintenance contracts with a contract period of one year or less as sales commissions paid on contract renewals are commensurate with those paid on the initial contract.

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

Cash and cash equivalents, which primarily include money market mutual funds, were \$49.0 million and \$51.6 million as of September 30, 2018 and December 31, 2017, respectively. We classified our cash equivalents of \$47.8 million and \$50.0 million as of September 30, 2018 and December 31, 2017 within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

As of September 30, 2018, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

	Fair Value Measurement at September 30, 2018 Using:		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds (included in cash and cash equivalents)	\$ 47,814		
Total	\$ 47,814	\$ -	\$ -

As of December 31, 2017, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

	Fair Value Measurement at December 31, 2017 Using:		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds (included in cash and cash equivalents)	\$ 49,986		
Total	\$ 49,986	\$ -	\$ -

- E) **Computation of Earnings per Share.** Basic earnings per share is computed by dividing net income or loss by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing net income or loss by the weighted average number of common shares outstanding plus additional common shares that would have been outstanding if dilutive potential common shares had been issued. For the purposes of this calculation, stock options are considered common stock equivalents in periods in which they have a dilutive effect. Stock options that are anti-dilutive are excluded from the calculation.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$ 1,277	\$ 1,145	\$ 594	\$ 1,560
Shares outstanding:				
Weighted-average common shares outstanding	21,564	21,679	21,548	21,900
Additional dilutive common stock equivalents	75	79	56	67
Diluted shares outstanding	21,639	21,758	21,604	21,967
Net income per share – basic	\$ 0.06	\$ 0.05	\$ 0.03	\$ 0.07
Net income per share – diluted	\$ 0.06	\$ 0.05	\$ 0.03	\$ 0.07

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Cost of services	\$ 7	\$ 4	\$ 15	\$ 8
Research and development	34	34	71	82
Selling and marketing	4	5	9	11
General and administrative	141	155	299	364
Stock-based compensation expense	\$ 186	\$ 198	\$ 394	\$ 465

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

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

We granted shares of unrestricted stock in 2018 and 2017 that affected financial results for the three and nine month periods ended September 30, 2018 and 2017. These grants are described below.

2018 Grant. On March 20, 2018, we granted 138,000 shares of unrestricted stock to directors, officers and employees. Half of those shares were issued on July 2, 2018 and the remaining 69,000 shares will be issued shortly after December 31, 2018, provided each grantee is serving as a director, officer or employee on those dates. The total stock-based compensation expense related to this grant is \$580,000, of which \$186,000 and \$394,000 was charged to expense in the three and nine months ended September 30, 2018 and we anticipate the remaining \$186,000 will be charged to expense in the fourth quarter of 2018.

The shares we issued on July 2, 2018 for the first installment of the 2018 grant included 57,592 net shares of common stock after employees surrendered 11,408 shares for which we paid \$51,000 of withholding taxes on their behalf.

2017 Grant. In February 2017, we granted 134,000 shares of unrestricted stock to directors, officers and employees. The shares were issued in two equal installments shortly after June 30, 2017 and December 31, 2017. We expensed the entire \$663,000 stock-based compensation expense related to this grant in 2017. We issued shares of common stock related to this grant as follows: i) 54,014 net shares of common stock were issued in early July 2017 after employees surrendered 12,986 shares for which we paid \$67,000 of withholding taxes on their behalf; and ii) 53,378 net shares of common stock were issued in early January 2018 after employees surrendered 13,622 shares for which we paid \$64,000 of withholding taxes on their behalf.

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

We conduct our operations in the United States and sell our products and services to domestic and international customers. Revenues were generated from the following geographic regions for the three and nine months ended September 30, 2018 and 2017 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
United States	\$ 1,516	\$ 5,215	\$ 5,107	\$ 10,335
United Kingdom	1,329	32	2,838	222
Brazil	2,128	60	2,308	217
Rest of World	428	400	1,820	1,631
	<u>\$ 5,401</u>	<u>\$ 5,707</u>	<u>\$ 12,073</u>	<u>\$ 12,405</u>

Revenue by product group for the three and nine months ended September 30, 2018 and 2017 was (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Biometrics	\$ 5,216	\$ 3,127	\$ 11,104	\$ 9,218
Imaging	185	2,537	969	3,060
DSL royalties	-	43	-	127
	<u>\$ 5,401</u>	<u>\$ 5,707</u>	<u>\$ 12,073</u>	<u>\$ 12,405</u>

Revenue by timing of transfer of goods or services for the three and nine months ended September 30, 2018 and 2017 was (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Goods or services transferred at a point in time	\$ 2,803	\$ 4,275	\$ 5,342	\$ 7,859
Goods or services transferred over time	2,598	1,432	6,731	4,546
	<u>\$ 5,401</u>	<u>\$ 5,707</u>	<u>\$ 12,073</u>	<u>\$ 12,405</u>

H) **Recently Adopted Accounting Pronouncements.**

FASB ASU No. 2014-09. In May 2014, the FASB issued Accounting Standard Update No. 2014-09, Revenue from Contracts with Customers (Topic 606). The ASU is the result of a joint project by the FASB and the International Accounting Standards Board (“IASB”) to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards (“IFRS”) that would: remove inconsistencies and weaknesses, provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices across entities, jurisdictions, industries, and capital markets, improve disclosure requirements and resulting financial statements, and simplify the presentation of financial statements. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. We adopted the standard on January 1, 2018 utilizing the full retrospective method.

We implemented new internal controls for the implementation and modified and augmented our existing internal controls to enable the preparation of financial information on adoption. The most significant impacts of adopting the new standard related to the following:

- i) 2015 imaging software license contract. We consummated a \$4.625 million license contract in October 2015 that included a \$4.5 million license fee plus a \$125,000 software maintenance fee. We delivered the licensed software and the customer paid us in the fourth quarter of 2015. Under legacy GAAP, we were unable to establish vendor specific objective evidence (“VSOE”) for the maintenance element and, as a result we recognized the total fee ratably over the twelve-month period that ran from October 2015 to October 2016. Under the new standard, license revenue of \$4.5 million from that contract is recognized in 2015 when control over the software was transferred to the customer and software maintenance revenue of \$125,000 is recognized ratably over the twelve-month period that ran from October 2015 to October 2016. This change resulted in a decrease in revenue of \$3.6 million for fiscal year 2016. This change had no impact to our reported results for the three and nine months ended September 30, 2017.
- ii) DSL royalty contracts. Under our legacy revenue recognition policy, we recognized DSL royalty revenue in the period in which we received royalty reports, which was typically in the quarter immediately following the quarter in which sales of royalty-bearing products occurred. Under the new standard, we recognize DSL royalty revenue in the quarter in which sales of royalty-bearing products occur. Therefore, we make estimates of royalties earned in the current period and record royalty revenue based on those estimates. This change resulted in a decrease in revenue of \$17,000 and \$39,000 for fiscal years 2017 and 2016, respectively. This change resulted in an increase in revenue of \$2,000 for the three months ended September 30, 2017, and an increase in revenue of \$9,000 for the nine months ended September 30, 2017.
- iii) Minimum license/royalty payment contract. One of our revenue contracts required the customer to make a fixed payment for professional services as well as minimum license/royalty payments for software to be distributed to end-users. Under legacy GAAP, we recognized the professional services fee over the period that the services were performed and revenue for the minimum license/royalty payments when those minimum payments became due. Under the new standard we recognized the estimated amount of total consideration, including the professional services fee and our estimate of variable consideration related to the minimum license/royalty payments, in the contract that we expect to be entitled to and recognized revenue in the period(s) that the related licenses and services were transferred to the customer. This change resulted in a decrease in revenue of \$800,000 for fiscal year 2017, \$200,000 of which related to the three months ended September 30, 2017 and \$600,000 of which related to the nine months ended September 30, 2017, an increase in revenue of \$860,000 for fiscal year 2016, an increase in unbilled receivables of \$1.4 million in fiscal year 2017, an increase in unbilled receivables of \$2.2 million in fiscal year 2016 and an increase in stockholders’ equity of \$2.2 million in fiscal year 2016.

iv) Sales commissions and other third-party acquisition costs. Under legacy GAAP, sales commissions and other third-party acquisition costs resulting directly from securing contracts with customers were expensed as incurred. ASC 340 requires these costs to be recognized as an asset when incurred and expensed over a period consistent with the period of transfer to the customer of goods or services to which the asset relates. We adopted the practical expedient that if the amortization period of the asset that we otherwise would have recognized is one year or less, we expense the sales commissions and other third-party acquisition costs resulting directly from securing contracts with customers when incurred. The adoption of the new standard resulted in a decrease in expense of approximately \$114,000 for fiscal year 2017, \$26,000 of which related to the three months ended September 30, 2017 and \$81,000 of which related to the nine months ended September 30, 2017, and \$294,000 for fiscal year 2016 and a decrease in stockholders' equity of \$0.3 million in fiscal year 2016. For fiscal year 2017, the decrease in expense primarily relates to lower sales commissions due to lower revenue on our minimum license/royalty payment contract as noted above. For fiscal year 2016, the decrease primarily relates to lower sales commissions due to lower revenue from our 2015 imaging software license contract and lower revenue on our minimum license/royalty payment contract as noted above.

Revenue recognition related to our other arrangements for software licenses, software maintenance, services, and hardware remained substantially unchanged.

As a practical expedient, for contracts that were modified before the earliest reporting period of application of the standard, we have not retrospectively restated the contracts for those contract modifications. Instead we have reflected the aggregate effect of all modifications that occurred before the earliest reporting period of application when (i) identifying the satisfied and unsatisfied performance obligations, (ii) determining the transaction price, and (iii) allocating the transaction price to the satisfied and unsatisfied performance obligations.

We have not restated contracts that began and were completed within the same annual reporting period. For completed contracts that have variable consideration, we have used the transaction price at the date the contract was completed rather than estimating variable consideration amounts in comparative reporting periods.

For fiscal years 2017 and 2016, adoption of the standard resulted in an aggregate decrease in revenue of \$0.8 million and \$2.8 million, respectively, a decrease in costs and expenses of \$0.1 million and \$0.3 million, respectively, a decrease in the provision for income taxes of \$0.4 million and \$1.0 million, respectively, and an increase in stockholders' equity of \$0.9 million and \$1.2 million respectively, primarily due to the changes noted above. In addition, adoption of the standard resulted in an increase in accounts receivable of \$1.4 million and \$2.2 million as of December 31, 2017 and 2016, respectively, driven by unbilled receivables from recognition of revenue from the estimate of variable consideration related to the minimum license/royalty payments in one of our contracts; a decrease in deferred tax assets of \$0.3 million and \$0.8 million as of December 31, 2017 and 2016, respectively, driven primarily by a difference in timing of revenue recognition and expenses for book and tax purposes; and an increase in accrued expenses of \$0.2 million and \$0.3 million as of December 31, 2017 and 2016, respectively, driven by sales commissions related to recognition of revenue from the estimate of variable consideration related to the minimum license/royalty payments in one of our contracts.

For the three and nine months ended September 30, 2017, adoption of the standard resulted in an aggregate decrease in revenue of \$198,000 and \$592,000, respectively, a decrease in costs and expenses of \$25,000 and \$82,000, respectively, and a decrease in the provision for income taxes of \$89,000 and \$207,000, respectively, primarily due to the same reasons noted above.

See Impacts of Topic 606 Adoption to Reported Results below for the impact of the adoption of the new standard on our consolidated financial statements.

Impacts of Topic 606 Adoption to Reported Results

Adoption of the new revenue standard impacted our reported results as follows:

	Three Months Ended September 30, 2017		
	As Reported	New Revenue Standard Adjustment	As Adjusted
(In thousands, except per share data)			
Consolidated Statements of Income:			
Revenue	\$ 5,905	\$ (198)	\$ 5,707
Costs and expenses	4,259	(25)	4,234
Provision for income taxes	545	(89)	456
Net income	1,229	(84)	1,145
Net income per share - basic and diluted	0.06	(0.01)	0.05

	Nine Months Ended September 30, 2017		
	As Reported	New Revenue Standard Adjustment	As Adjusted
(In thousands, except per share data)			
Consolidated Statements of Income:			
Revenue	\$ 12,997	\$ (592)	\$ 12,405
Costs and expenses	12,131	(82)	12,049
Provision for income taxes	742	(207)	535
Net income	1,863	(303)	1,560
Net income per share - basic	0.09	(0.02)	0.07
Net income per share - diluted	0.08	(0.01)	0.07

	September 30, 2017		
	As Reported	New Revenue Standard Adjustment	As Adjusted
(In thousands)			
Consolidated Balance Sheets:			
Accounts receivable, net	\$ 5,616	\$ 1,643	\$ 7,259
Prepaid expenses and other current assets	315	14	329
Deferred tax assets	5,648	(545)	5,103
Accrued expenses	1,272	251	1,523
Stockholders' equity	60,589	861	61,450

Adoption of the new revenue standard had no impact on total cash provided from or used in operating, financing, or investing in our consolidated statements of cash flows.

1) Recent Accounting Pronouncements Not Yet Adopted.

FASB ASU No. 2016-13. In June 2016, the FASB issued Accounting Standard Update No. 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." This new standard replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For trade and other receivables, loans, and other financial instruments, entities will be required to use a forward-looking expected loss model rather than the incurred loss model for recognizing credit losses which reflects losses that are probable. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. This standard is effective for fiscal years beginning after December 15, 2019 with early adoption permitted in fiscal years beginning after December 15, 2018. We are currently evaluating the effect this standard will have on our consolidated financial statements and related disclosures.

With the exception of the standard discussed above, there have been no other recently issued accounting pronouncements that are of significance or potential significance to us that we have not adopted as of September 30, 2018.

- J) **Income Taxes.** Income tax expense was \$89,000 and \$31,000 for the three and nine months ended September 30, 2018, respectively. Income tax expense in the three and nine month periods ended September 30, 2018 was based on the U.S. statutory rate of 21%, increased by state income taxes, and reduced by permanent adjustments and research tax credits. Income tax expense was \$456,000 and \$535,000 for the three and nine months ended September 30, 2017, respectively. Income tax expense in the three and nine month periods ended September 30, 2017 was based on the U.S. statutory rate of 34%, increased by state income taxes, and reduced by permanent adjustments and research tax credits.

As of September 30, 2018, we had a total of \$5.2 million of deferred tax assets for which we had recorded no valuation allowance. We have assessed the need for a valuation allowance on our deferred tax assets. Based on our assessment of future sources of income, including reversing deferred tax liabilities, and future earnings, we have determined that it is more likely than not that the deferred tax assets will be realized, and therefore there is no valuation allowance required for the deferred tax assets. We will continue to assess the level of valuation allowance in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

In the second quarter of 2017, the Internal Revenue Service commenced an examination of our tax return for the year ended December 31, 2015. In February 2018, the IRS notified us that it had completed its examination and that it had no changes to our reported tax.

- K) **Share Repurchase Program.** On April 24, 2018, we announced that our Board of Directors had approved a program authorizing the Company to purchase up to \$10 million of our common stock. The shares may be purchased from time to time in the open market or through privately negotiated transactions at management's discretion, depending upon market conditions and other factors. The authorization to repurchase our stock expires on December 31, 2019. We repurchased 32,596 shares of common stock under this program for a total cost of \$122,000 during the three months ended September 30, 2018. Since the program commenced in April 2018, we have repurchased 66,367 shares for a total cost of \$260,000.
- L) **Income from patent arrangement.** We entered into an arrangement with an unaffiliated third party in 2010 under which we assigned certain patents in return for royalties on proceeds from patent monetization efforts by the third party. The third party has engaged in various patent monetization activities, including enforcement, litigation and licensing. In the three and nine months ended September 30, 2018, the third party reported and we recorded \$1,000 of income from this arrangement. In the three and nine months ended September 30, 2017, the third party reported and we recorded \$19,000 and \$1.4 million, respectively, of income from this arrangement.

ITEM 2:
Management's Discussion and Analysis of
Financial Condition and Results of Operations

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

Some of the information in this Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as "may," "will," "expect," "anticipate," "believe," "estimate," "continue" and similar words. You should read statements that contain these words carefully because they: (1) discuss our future expectations; (2) contain projections of our future operating results or financial condition; or (3) state other "forward-looking" information. However, we may not be able to predict future events accurately. The risk factors listed in our Annual Report on Form 10-K for the year ended December 31, 2017, as well as any cautionary language in this Form 10-Q, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this Form 10-Q could materially and adversely affect our business.

Summary of Operations

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

Effective January 1, 2018, we adopted ASC 606 using the full retrospective transition method. Adoption of the standard using the full retrospective method required us to restate certain previously reported results. Refer to Note H – Recently Adopted Accounting Pronouncements for further information on the impacts of adopting ASC 606.

Summary of Financial Results

We use revenue and operating income to summarize financial results as we believe these measurements are the most meaningful way to understand our operating performance.

Revenue and operating income for the three months ended September 30, 2018 were \$5.4 million and \$1.1 million, respectively. These results compared to revenue of \$5.7 million and operating income of \$1.5 million in the three months ended September 30, 2017. Lower revenue in the current year three month period was primarily due to lower imaging revenue. This was partially offset by higher biometrics license, maintenance and services revenue. Lower operating income in the current quarter as compared to the prior year quarter was primarily due to: i) lower revenue in the current quarter; ii) lower patent related income; and iii) higher total costs and expenses.

Revenue and operating income for the nine months ended September 30, 2018 were \$12.1 million and \$38,000, respectively. These results compared to revenue of \$12.4 million and operating income of \$1.8 million in the nine months ended September 30, 2017. Lower revenue in the current year nine month period was primarily due to lower imaging revenue and to a lesser extent lower royalty revenue. This was partially offset by higher biometrics license, maintenance and services revenue. Lower operating income in the current year nine month period was primarily due to: i) lower revenue in the current nine month period; and ii) lower patent related income.

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

Results of Operations

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

Software license revenue decreased 19% from \$4.2 million in the three months ended September 30, 2017 to \$3.4 million in the same three month period in 2018. As a percentage of total revenue, software license revenue decreased from 74% in the third quarter of 2017 to 64% in the current year quarter. The \$0.8 million decrease in software license revenue was primarily due to: i) a \$2.4 million decrease in imaging software license sales, which was partially offset by; ii) a \$1.6 million increase in biometrics software license sales. The reasons for the changes in imaging and biometrics software licenses were:

- i) Biometrics software licenses – Biometrics software license sales were \$3.3 million in the third quarter of 2018 versus \$1.7 million in the same quarter last year. The dollar increase was primarily due to: i) a software license agreement we entered with a large commercial customer during the quarter; and ii) revenue from the software license agreement we entered into with a systems integrator in the second quarter of 2018. We recognized \$0.6 million of software license revenue from this agreement in the third quarter of 2018. We also provide engineering services to this systems integrator pursuant to this arrangement. We expect our development effort on this project to continue for approximately the next three to four quarters. The dollar increase was partially offset by lower revenue from our other biometric license customers.
- ii) Imaging software licenses – Imaging software license sales were \$0.1 million in the third quarter of 2018 versus \$2.5 million in the same quarter last year. The dollar decrease was primarily due to the impact of a software license agreement we entered into with a medical imaging customer in the third quarter of 2017 whereas there was no such imaging software sale in the third quarter of 2018.

Software license revenue decreased 15% from \$7.7 million in the nine months ended September 30, 2017 to \$6.6 million in the same nine month period in 2018. As a percentage of total revenue, software license revenue decreased from 62% in the first nine months of 2017 to 55% in the corresponding period of 2018. The \$1.1 million decrease in software license revenue was primarily due to a \$2.1 million decrease in imaging software license sales, which was partially offset by a \$1.0 million increase in biometrics software license sales. The reasons for the changes in imaging and biometrics software licenses were:

- i) Biometrics software licenses – Biometrics software license sales were \$5.7 million in the nine months ended September 30, 2018 versus \$4.8 million in the corresponding period a year ago. The dollar increase was primarily due to: i) a software license agreement we entered into with a large commercial customer during the third quarter; and ii) revenue from the software license agreement we entered into with a systems integrator in the second quarter of 2018. We recognized \$1.2 million of software license revenue from this agreement in the first nine months of 2018. The dollar increase was partially offset by lower revenue from our government customers and our other biometric license customers.
- ii) Imaging software licenses – Imaging software license sales were \$0.8 million in the nine months ended September 30, 2018 versus \$3.0 million in the corresponding period a year ago. The dollar decrease was primarily due to the impact of a software license agreement we entered into with a medical imaging customer in the third quarter of 2017 whereas there was no such imaging software sale in the first nine months of 2018.

As described in the strategy section of our Form 10-K for the year ended December 31, 2017, our market strategy is to continue to focus on our legacy government biometrics markets and expand into new commercial biometrics markets. We are unable to predict future revenue from commercial markets as these are emerging markets.

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

Software maintenance revenue increased 19% from \$1.1 million in the three months ended September 30, 2017 to \$1.3 million in the same three month period in 2018. As a percentage of total revenue, software maintenance revenue increased from 19% in the third quarter of 2017 to 24% in the current year quarter.

Software maintenance revenue increased 10% from \$3.6 million in the nine months ended September 30, 2017 to \$4.0 million in the same nine month period in 2018. As a percentage of total revenue, software maintenance revenue increased from 29% in the first nine months of 2017 to 33% in the corresponding period of 2018.

For the three and nine month periods ended September 30, 2018, the dollar increase in software maintenance revenue was primarily due to higher retention of maintenance renewals in current periods.

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

Services increased 91% from \$0.3 million in the three months ended September 30, 2017 to \$0.7 million in the same three month period in 2018. As a percentage of total revenue, services increased from 6% in the third quarter of 2017 to 12% in the current year quarter.

Services increased 62% from \$0.9 million in the nine months ended September 30, 2017 to \$1.5 million in the same nine month period in 2018. As a percentage of total revenue, services increased from 7% in the first nine months of 2017 to 12% in the corresponding period of 2018.

For the three and nine month periods ended September 30, 2018, the dollar increase in services revenue was primarily due to higher services revenue related to the software license agreement we entered into with a systems integrator in the second quarter of 2018 for a large project, which was partially offset by lower service revenue from our other service customers.

We expect our development effort on this large project to continue for approximately the next three to four quarters.

Services backlog was \$1.3 million as of September 30, 2018.

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

Royalties decreased 100% from \$43,000 in the three months ended September 30, 2017 to zero in the same three month period in 2018. Royalties decreased 100% from \$127,000 in the nine months ended September 30, 2017 to zero in the same nine month period in 2018.

We do not consider DSL royalties to be a key element of our strategy and we believe that it is unlikely we will receive DSL royalties in future periods.

Cost of software licenses. Cost of software licenses consists primarily of the cost of third party software included in certain software products delivered to the U.S. Marine Corps ("USMC") and U.S. Navy (the "Navy").

Cost of software licenses decreased 27% from \$27,000 in the three months ended September 30, 2017 to \$20,000 in the same three month period in 2018. Cost of software licenses as a percentage of software license sales was 1% in the first three months of 2017 and 2018. The dollar decrease in cost of software licenses was primarily due to lower sales of software to the Navy that included third party software.

Cost of software licenses decreased 93% from \$274,000 in the nine months ended September 30, 2017 to \$20,000 in the same nine month period in 2018. Cost of software licenses as a percentage of software license sales decreased from 4% in the first nine months of 2017 to less than 1% in the corresponding period of 2018. The dollar decrease in cost of software licenses was primarily due to no sales of software to the USMC and to lower sales of software to the Navy that included third party software.

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

Cost of services increased 79% from \$179,000 in the three months ended September 30, 2017 to \$320,000 in the same three month period in 2018. Cost of services as a percentage of services revenue decreased from 52% in the third quarter of 2017 to 49% in the current year quarter, which means that gross margins increased from 48% to 51%.

Cost of services increased 48% from \$499,000 in the nine months ended September 30, 2017 to \$740,000 in the same nine month period in 2018. Cost of services as a percentage of services revenue decreased from 54% in the first nine months of 2017 to 49% in the corresponding period of 2018, which means that gross margins increased from 46% to 51%.

For both the three and nine month periods, the dollar increase in cost of services was primarily due to a large project with a systems integrator that we signed in the second quarter of 2018. The increase was partially offset by lower services revenue from our other customers. We anticipate further cost of services from this project over the next three to four quarters.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Research and development expense	\$ 1,816	\$ 2,151	\$ 5,579	\$ 5,884
Cost of services	320	179	740	499
Total engineering costs	\$ 2,136	\$ 2,330	\$ 6,319	\$ 6,383

Research and development expense decreased from \$2.2 million in the three months ended September 30, 2017 to \$1.8 million in the same three month period of 2018. As a percentage of total revenue, research and development expense decreased from 38% in the third quarter of 2017 to 34% in the corresponding period of 2018.

Research and development expense decreased from \$5.9 million in the nine months ended September 30, 2017 to \$5.6 million in the same nine month period of 2018. As a percentage of total revenue, research and development expense decreased from 47% in the first nine months of 2017 to 46% in the corresponding period of 2018.

As the table immediately above indicates, total engineering costs in the third quarter of 2018 decreased by \$194,000 compared to the same period last year. The spending decrease was primarily due to lower spending on third-party development costs, which was partially offset by higher employee costs. Total engineering costs decreased by \$64,000 for the nine months ended September 30, 2018 as compared to the same period last year. The spending decrease was primarily due to lower spending on third-party development costs, which was partially offset by higher employee costs and recruiting fees.

We anticipate that we will continue to focus our future research and development activities on enhancing our existing products and developing new products.

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

Sales and marketing expense increased 26% from \$1.0 million in the three months ended September 30, 2017 to \$1.3 million in the same three month period of 2018. As a percentage of total revenue, sales and marketing expense increased from 18% in the third quarter of 2017 to 24% in the corresponding period in 2018. The dollar increase in sales and marketing expense was primarily due to higher sales commissions, which was partially offset by lower advertising and tradeshows costs, and lower travel costs.

Sales and marketing expense increased 10% from \$2.9 million in the nine months ended September 30, 2017 to \$3.2 million in the same nine month period of 2018. As a percentage of total revenue, sales and marketing expense increased from 24% in the first nine months of 2017 to 27% in the corresponding period of 2018. The dollar increase in sales and marketing expense was primarily due to higher sales commissions and to a lesser extent higher employee costs, which was partially offset by lower spending on sales agents.

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

General and administrative expense decreased 5% from \$849,000 in the three months ended September 30, 2017 to \$807,000 in the same three month period in 2018. As a percentage of total revenue, general and administrative expense was 15% for both three month periods. The decrease in general and administrative expense was primarily due to lower professional fees.

General and administrative expense was \$2.5 million in both nine months ended September 30, 2017 and 2018. As a percentage of total revenue, general and administrative expense was 20% for both nine month periods. Although general and administrative expense was essentially unchanged, lower stock based compensation expense was offset by higher professional fees and to a lesser extent other expenses.

Patent related income. We entered into an arrangement with an unaffiliated third party in 2010 under which we assigned certain patents in return for royalties on proceeds from patent monetization efforts by the third party. The third party has engaged in various patent monetization activities, including enforcement, litigation and licensing. In the three and nine months ended September 30, 2018, the third party reported and we recorded \$1,000 of income from this arrangement. In the three and nine months ended September 30, 2017, the third party reported and we recorded \$19,000 and \$1.4 million, respectively, of income from this arrangement. We continue to have a contractual relationship with this third party. However, we are unable to predict how much more income we might receive from this arrangement, if any, because we do not know whether any patent monetization efforts by the third party will be successful.

Interest income. Interest income increased 106% from \$109,000 in the three months ended September 30, 2017 to \$224,000 in the same three month period in 2018. Interest income increased 109% from \$281,000 in the nine months ended September 30, 2017 to \$587,000 in the same nine month period in 2018. For the three and nine month periods, the dollar increase in interest income was primarily due to higher interest rates within our money market accounts.

Income taxes. Income tax expense was \$89,000 and \$31,000 for the three and nine months ended September 30, 2018, respectively. Income tax expense in the three and nine month periods ended September 30, 2018 was based on the U.S. statutory rate of 21%, increased by state income taxes, and reduced by permanent adjustments and research tax credits. Income tax expense was \$456,000 and \$535,000 for the three and nine months ended September 30, 2017, respectively. Income tax expense in the three and nine month periods ended September 30, 2017 was based on the U.S. statutory rate of 34%, increased by state income taxes, and reduced by permanent adjustments and research tax credits.

As of September 30, 2018, we had a total of \$5.2 million of deferred tax assets for which we had recorded no valuation allowance. We have assessed the need for a valuation allowance on our deferred tax assets. Based on our assessment of future sources of income, including reversing deferred tax liabilities, and future earnings, we have determined that it is more likely than not that the deferred tax assets will be realized, and therefore there is no valuation allowance required for the deferred tax assets. We will continue to assess the level of valuation allowance in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

In the second quarter of 2017, the Internal Revenue Service commenced an examination of our tax return for the year ended December 31, 2015. In February 2018, the IRS notified us that it had completed its examination and that it had no changes to our reported tax.

Liquidity and Capital Resources

At September 30, 2018, we had cash and cash equivalents of \$49.0 million, which represented a decrease of \$2.6 million from December 31, 2017. The decrease in cash and cash equivalents was primarily due to the following factors:

Cash used in operations was \$2.2 million in the first nine months of 2018. Cash used from operations was primarily the result of \$3.5 million of changes in assets and liabilities. Cash used from these sources was partially offset by \$0.6 million of net income and the add back of \$0.7 million of non-cash items primarily for depreciation, amortization, and stock-based compensation.

Cash used in investing activities was \$142,000 in the first nine months of 2018. This cash usage consisted of purchases of property and equipment.

Cash used in financing activities was \$340,000 in the first nine months of 2018. Financing activity cash usage was primarily the result of \$260,000 used to buy back stock under our stock repurchase program and \$107,000 used to pay income taxes for employees who surrendered shares in connection with stock grants. Cash used for these purposes was partially offset by \$27,000 of proceeds from our employee stock purchase program.

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.

Recently Adopted 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 at September 30, 2018 consisted of one element:

Cash and cash equivalents. As of September 30, 2018, our cash and cash equivalents of \$49.0 million were primarily invested in money market funds. The money market funds were invested in high quality, short term financial instruments. Due to the nature, short duration, and professional management of these funds, we do not expect that a general increase in interest rates would result in any material loss.

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

ITEM 4:
Controls and Procedures

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective.

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We implemented internal controls to ensure we adequately evaluated our contracts and properly assessed the impact of the new accounting standard related to revenue recognition on our financial statements to facilitate their adoption on January 1, 2018. There were no significant changes to our internal control over financial reporting due to the adoption of the new standard.

PART II. OTHER INFORMATION

ITEM 1: Legal Proceedings

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

ITEM 1A: Risk Factors

The risks described in Item 1A, Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2017, could materially and adversely affect our business, financial condition and results of operations. The risk factors discussed in that Form 10-K do not identify all risks that we face because our business operations could also be affected by additional factors that are not presently known to us or that we currently consider to be immaterial to our operations. No material change in the risk factors discussed in that Form 10-K has occurred.

ITEM 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 (1)	(d) Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs
July 2018	2,697	\$ 3.85	2,697	-
August 2018	20,101	\$ 3.76	20,101	-
September 2018	9,798	\$ 3.72	9,798	\$ 9,740,106

(1) On April 24, 2018, we issued a press release announcing that our board of directors had approved the repurchase of up to \$10,000,000 of our common stock from time to time through December 31, 2019. During the three months ended September 30, 2018, we purchased 32,596 shares under this plan at an aggregate purchase price of \$122,410.

ITEM 4: Mine Safety Disclosures

Not applicable.

**ITEM 6:
Exhibits**

(a) Exhibits

<u>Exhibit 10.1*</u>	<u>Aware, Inc. 2018 Executive Bonus Plan (incorporated by reference to Exhibit 10.1 to Aware, Inc. Current Report on Form 8-K filed with the SEC on July 27, 2018).</u>
<u>Exhibit 31.1</u>	<u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
<u>Exhibit 31.2</u>	<u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
<u>Exhibit 32.1</u>	<u>Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
Exhibit 101	The following financial statements from Aware, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in XBRL (eXtensible Business Reporting Language), as follows: (i) Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017, (ii) Consolidated Statements of Income and Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and September 30, 2017, (iii) Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and September 30, 2017, and (iv) Notes to Consolidated Financial Statements.

*Management contract or compensatory contract.

SIGNATURES

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

AWARE, INC.

Date: October 26, 2018

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

Date: October 26, 2018

By: /s/ David J. Martin
David J. Martin
Chief Financial Officer (Principal Financial and Accounting Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Kevin T. Russell, Chief Executive Officer & President of Aware, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Aware, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 26, 2018

/s/ Kevin T. Russell
Kevin T. Russell
Chief Executive Officer & President

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, David J. Martin, Chief Financial Officer of Aware, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Aware, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 26, 2018

/s/ David J. Martin
David J. Martin
Chief Financial Officer

**CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report on Form 10-Q of Aware, Inc. (the "Company") for the quarter ended September 30, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), each of the undersigned Chief Executive Officer and Chief Financial Officer of the Company, certifies, to the best knowledge and belief of the signatory, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Kevin T. Russell
Chief Executive Officer & President

/s/ David J. Martin
Chief Financial Officer

Date: October 26, 2018

Date: October 26, 2018

The certification set forth above is being furnished as an exhibit solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and is not being filed as part of the Form 10-Q or as a separate disclosure document of the Company or the certifying officers.
