Aware, Inc.

2003 Annual Report

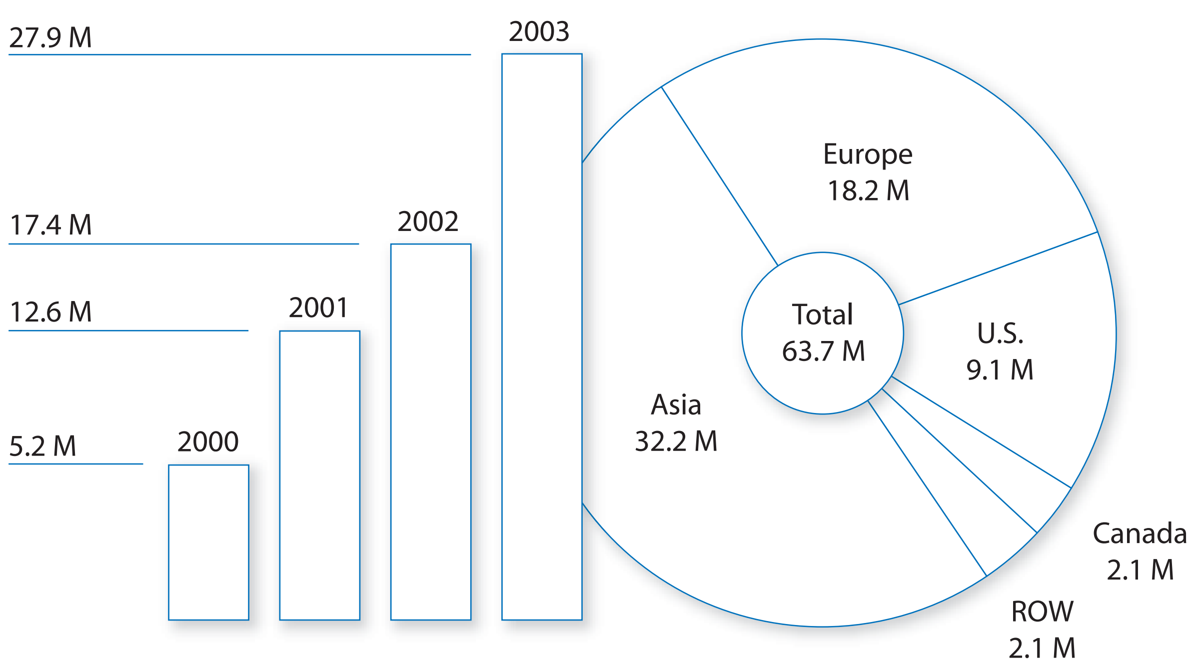
Aware, Inc.

Full Speed Ahead

- 63 million ADSL subscribers represent 6% of the world's one billion phone lines.*
- 30% of worldwide Internet users today use ADSL.*
- DSL Forum projects a total of 200 million ADSL lines will be in service by the end of 2005.
- New ADSL2 and ADSL2plus standards enable delivery of broadband applications including "triple play" video/voice/data.
- Aware's *StratiPHY2+*™ silicon platform was the first commercially available ADSL2plus compliant chipset.

ADSL Subscriber Net Additons by Year at 12/31/03 (millions)*

Cummulative ADSL Subscribers by Region at 12/31/03 (millions)*



** Point Topic, March 2004*

Letter to Shareholders

Dear Shareholders,

Important shifts are underway in the ADSL industry which will have a positive effect on Aware. Historically, ADSL lines have been used for broadband Internet access, but starting this year, telephone companies worldwide will begin to deploy a new set of applications based on new ADSL capabilities and standards. Aware is at the center of these new applications with our latest chipsets, software, and expertise. This makes us optimistic that with our new products, we will be able to take the necessary steps to return to previous revenue and profitability levels.

Over the last few years, we pursued an aggressive program of product development and active standards participation in anticipation of the current shift to new applications and features in the ADSL industry. In 2003, we were first to market with a digital chip that supports the new International Telecommunications Union standards known as ADSL2 and ADSL2plus.

Future deployments will benefit from improved line diagnostics, power management, power down and cutback, reduced framing, and on-line reconfiguration. In addition, the new standards expand service availability and increase customer data rates to allow simultaneous data, voice, and video service. At the same time, service providers are expanding their offerings to support music and video sharing, streaming media applications, instant messaging, gaming, and broadcast TV.

Aware's primary product offering is a comprehensive digital chip and software technology package that supports ADSL, ADSL2 and ADSLplus standards, and enables our customers to enter the market rapidly. Our two largest customers, Analog Devices and Infineon, are already taking advantage of the leadership position that our latest technology provides to them.

Telephone companies are faced with a myriad of questions and issues when deploying ADSL service. We have developed hardware and software products aimed at the test and diagnostics ADSL market. Aware's *Dr. DSL*® is gaining marketplace traction, and we look forward to a healthy business in future years as service providers deal with rollout and maintenance issues.

Our imaging and biometrics software business is targeted at a growing industry segment. We are increasing our focus to take advantage of increasing security investments inside the government and in the commercial sector. This is an area we have been active in for many years and see several growth opportunities. Also, we have continued to develop next generation wireless local area networking technology, focused on solutions that expand data rates beyond 100 Mbps.

We ended 2003 with $39 million in cash and investments, and have maintained our ability to invest in the promising markets that we are targeting.

We want to thank our shareholders, our customers, and our employees for their continued support. The ADSL industry is entering its second phase of deployments, characterized by better standards, more mature service offerings, and increased focus on testing and maintaining lines of service. We remain confident that we have positioned Aware to benefit as these markets develop further.

Sincerely,

Michael A. Tzannes
Chief Executive Officer

John K. Kerr
Chairman,
Board of Directors

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2003

Commission file number 000-21129

AWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

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

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

Securities registered pursuant to Section 12(b) of the Act: **None**
Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $.01 per share
(Title of class)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2).
YES _X_ NO ___

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2003, based on the closing price of the common stock on June 30, 2003 as reported on the Nasdaq National Market, was approximately $51,341,703.

The number of shares outstanding of the registrant's common stock as of March 2, 2004 was 22,750,294.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement to be delivered to shareholders in connection with the registrant's Annual Meeting of Shareholders to be held on May 27, 2004 are incorporated by reference into Part III of this Annual Report on Form 10-K.

AWARE, INC.
FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2003

TABLE OF CONTENTS

PART I

ITEM 1. DESCRIPTION OF THE BUSINESS

Company Overview

We are a worldwide leader in the development and marketing of intellectual property for broadband communications. We license our intellectual property to semiconductor companies that build integrated circuits based on our technology. Our principal offering to date has been Digital Subscriber Line ("DSL") technology for the telecommunications industry. DSL enables telephone companies to use their existing copper telephone lines to offer broadband services.

Our principal DSL offering is a technology package for Asymmetric Digital Subscriber Line ("ADSL"). ADSL is a broadband service that is primarily targeted at residential telephone customers for high-speed Internet access. ADSL has been standardized for global use by the International Telecommunications Union ("ITU"). Our ADSL technology package is compliant with applicable ITU standards.

We have complemented our core ADSL technology offering with technologies aimed at enhancing the value of ADSL to telephone companies. We also have projects underway to develop other forms of DSL, as well as other broadband technologies. We play an active role in setting standards for broadband technologies so that we can anticipate and develop technology that meets the needs of changing markets.

During 2002 and 2003, approximately 64% and 56%, respectively, of our revenue came from licensing ADSL intellectual property. We license our intellectual property worldwide through our direct sales force. Our largest semiconductor customers in 2003 were Analog Devices, Inc. and Infineon Technologies, AG. The remainder of our revenue came from the sale of hardware and software products. Our hardware products include board-level products that allow customers to make products that require ADSL connectivity, such as ADSL test equipment. Our hardware products also include system-level products that enable our customers to develop and test their ADSL products. Our software products compress digital images and data for law enforcement and other applications.

We are headquartered in Bedford, Massachusetts. Our telephone number is (781) 276-4000, and our website is www.aware.com. Incorporated in Massachusetts in 1986, we employed 111 people at December 31, 2003. Our stock is traded on the Nasdaq National Market under the symbol AWRE.

Our website provides a link to a third-party website through which our annual, quarterly and current reports, and amendments to those reports, are available free of charge. We believe these reports are made available as soon as reasonably practicable after we electronically file them with, or furnish them to, the SEC. We do not maintain or provide any information directly to the third-party website, and we do not check its accuracy.

Industry Background

ADSL industry background. ADSL technology allows telephone companies to offer high-speed data services over their existing telephone networks by connecting their central offices to end users' residences. Telephone companies began tests and trials of ADSL technology in the mid 1990s. Commercial deployment of ADSL services began in modest volumes in 1999, and during the last four years, the rate of deployment of ADSL services accelerated dramatically, particularly outside of the United States. According to announcements by major telephone companies and information compiled by Point Topic Ltd., a company that provides analysis of broadband access to the internet, approximately 5 million, 12 million, 17 million, and 28 million new ADSL subscribers were added in 2000, 2001, 2002, and 2003, respectively. As of December 31, 2003, there were approximately 64 million global ADSL subscribers of which approximately 9 million were in the United States and approximately 55 million were in other countries.

Some of the largest suppliers of ADSL service in North America are SBC, Verizon, Bell South, Qwest, and Bell Canada. In Europe, some of the largest providers are Deutsche Telekom, France Telecom, Belgacom, British

Telecom, Telephonica, Telecom Italia, and Telia. Large Asian providers include Korea Telecom and Hanaro in Korea; NTT and Yahoo Broadband in Japan; Chunghwa in Taiwan; and China Telecom in China.

In order to enable ADSL service, ADSL equipment must be installed in the central offices of telephone companies and in end users' premises. ADSL central office equipment and customer premises modems are available from numerous telecommunications equipment suppliers. Some of the leading suppliers of ADSL equipment include Alcatel Alsthom S.A. ("Alcatel"), ECI Telecom, Lucent Technologies, Inc., NEC Corporation, Samsung Corporation, Siemens AG, Sumitomo Corporation, UT Starcom, Westell Technologies, Inc., and Comtrend and other Taiwanese modem manufacturers.

Telecommunications equipment suppliers are able to purchase ADSL chipsets from a number of suppliers, including Analog Devices Inc. ("ADI"), Broadcom Corporation ("Broadcom"), Centillium Communications, Inc. ("Centillium"), Conexant Systems, Inc. ("Conexant"), Infineon Technologies AG ('Infineon"), ST Microelectronics N.V. ("ST"), and Texas Instruments Incorporated ("TI"). ADSL chipsets offered by these suppliers are designed to operate in either central office equipment or customer premises modems.

Semiconductor industry background. During the 1980s and 1990s, the semiconductor industry moved from vertically integrated companies to horizontally specialized companies. Vertically integrated semiconductor companies used to perform the entire semiconductor process from design to manufacture to sales. Today the industry consists of separate companies focused on various horizontal processes within the semiconductor industry. Horizontal groups within the semiconductor industry now include capital equipment companies, independent foundries, design automation shops, fabless semiconductor companies, and semiconductor intellectual property ("IP") companies.

The semiconductor intellectual property industry has matured and grown over the last five years. The availability of field-proven technology from independent IP suppliers allows semiconductor manufacturers to achieve greater financial flexibility, reduce engineering development risks, and reduce the time it takes to get products to market.

Semiconductor intellectual property may be classified into two principal categories:

- *Horizontal IP* consists of designs for: (i) standard chip functions, such as timers and clocks, memory management, and hardware controllers, (ii) configurable processors and digital signal processors, and (iii) libraries of intellectual property that are used during the semiconductor manufacturing process.

- *Vertical IP* consists of solutions for specific applications that are usually based on standards or patents. Examples include ADSL, Code Division Multiple Access ("CDMA"), Universal Serial Bus ("USB"), Global System for Mobile telecommunications ("GSM"), Global Positioning System ("GPS"), Wireless Local Area Networking ("WLAN"), and chip-connection technology for Dynamic Random Access Memory ("DRAM").

Our intellectual property is focused on Vertical IP for applications involving broadband communications, and in particular ADSL.

Aware ADSL Intellectual Property

ADSL technology was first created in the late 1980s. ADSL technology expands the usable bandwidth of copper wire so that telephone companies can offer high-speed data services over their existing telephone networks. ADSL is a point-to-point technology that connects the end user to a telephone company's central office. ADSL equipment is deployed at each end of the copper wire in order to enable the service. ADSL is targeted at the residential market and is designed to transmit data at speeds more than 100 times faster than 56 kilobits per second ("Kbps") voiceband modems. Actual transmission speeds depend on the length and condition of the existing wire.

An ADSL system divides the bandwidth on a copper wire into three segments. The first segment is used for plain old telephone service ("POTS"). The second segment is used to transmit data upstream from the user to the central office. The third segment is used to transmit data downstream from the central office to the user.

Full-rate ADSL was first standardized in 1995 by the American National Standards Institute as T1.413, and then by the ITU in 1999 as G.992.1. Full-rate ADSL can transmit data at speeds up to 8 megabits per second ("Mbps") downstream and up to 640 Kbps upstream.

In 1999, the ITU also standardized a lower speed version of ADSL, known as G.Lite or G.992.2. G.Lite can transmit data at speeds up to 1.5 Mbps downstream and up to 512 Kbps upstream without using special filtering equipment required by full-rate ADSL. G.Lite was intended to make the installation of ADSL faster and less expensive for telephone companies. Notwithstanding G.Lite's ease of installation, most ADSL service offerings today are based on full-rate ADSL.

In 2002, the ITU consented to a new set of ADSL standards known as ADSL2 or G.992.3 and G.992.4. These standards provide numerous improvements over previous ADSL standards, including line diagnostics, power management, power down and power cut-back, reduced framing and on-line configuration. In February 2003, the ITU consented to a new standard known as ADSL2+ or G.992.5. ADSL2+ builds upon the ADSL2 standard by increasing achievable data rates to speeds of up to 24 Mbps upstream on phone lines as long as 3,000 feet (20 Mbps out to 5,000 feet).

We license a technology package that includes a complete implementation of the ITU standards for ADSL, ADSL2 and ADSL2+. Our intellectual property offering includes chip designs, in the form of RTL, and software for operating the chip. In January 2003, we announced that we had developed and manufactured a physical chip named StratiPHY™ that represents our intellectual property designs. The addition of StratiPHY to Aware's intellectual property offering provides our customers with access to working silicon along with a complete turnkey package of RTL and firmware. We believe the addition of a physical chip to our intellectual property offerings has the potential of further reducing our customers' development costs and time-to-market.

Customers can integrate our technology into their own or third party manufacturing processes to develop monolithic chips or packaged solutions. We also license patent rights and offer engineering services to our customers.

We have complemented our core ADSL offerings with technologies aimed at enhancing the value proposition of ADSL for telephone companies. An important innovation we have developed is our Dr. DSL® diagnostic testing technology. Dr. DSL is designed to assist service providers with provisioning, monitoring, and maintaining their DSL services by enabling them to collect important information about their copper loop plant and the access network. Dr. DSL also has the potential of providing subscribers with tools they can use to assist with provisioning and maintenance. The primary goal of Dr. DSL is to reduce the costs associated with service turn-on and maintenance by reducing customer complaints and technician visits to subscriber locations. Specific Dr. DSL features include loop length measurement, bridged tap measurement, crosstalk disturber detection and management, subscriber self-installation, and in-home diagnostics. We have also developed channelized voice technology, named voice-enabled DSL (VeDSL™), which allows service providers to bundle new, profitable voice-over-DSL services to their residential subscribers, enabling ADSL to evolve from a data-centric technology to a complete residential voice and data solution.

Aware Business Model & Strategy

We have adopted an intellectual property business model under which we license our broadband technology on a nonexclusive and worldwide basis to semiconductor companies that manufacture and sell products that incorporate our technology. Our licensees sell integrated circuits to equipment companies that incorporate those integrated circuits into their products.

Our business model and strategy are designed to:

- offer the semiconductor industry an independent source of broadband technology*;*
- provide multiple and flexible technology solutions for numerous silicon and equipment architectures;
- offer systems-level, vertical intellectual property for specific applications that are based on worldwide standards;

- leverage our customers' distribution capabilities;
- contribute to industry standards by offering our expertise, which allows us to anticipate technological changes; and
- generate revenue through a combination of license fees, engineering service fees, and royalties.

Aware ADSL Hardware Products

In addition to our intellectual property licensing business, we sell ADSL-related hardware products. Our principal hardware products include:

- *ADSL modules* - Modules are board-level products that contain all of the components of an ADSL system. Customers, such as ADSL test equipment companies, can integrate ADSL connectivity into their equipment-based products using our ADSL modules;
- *ADSL development systems* - Development systems are system-level products that are designed to help our customers build ADSL chipsets by providing them with a means to conduct performance and interoperability testing during product development; and
- *ADSL test systems* - Test systems are systems-level products that are designed to help ADSL modem manufacturers test their products during production without requiring them to purchase expensive central office equipment.

Aware Compression Software Products

We also develop and sell image and data compression products. Since 1988, we have developed intellectual property in the field of wavelet transform-based data compression. Our compression technology enables digital images and certain types of data to be compressed to between 1% and 10% of their original size. Our compression software products are sold to OEMs that integrate the software into their equipment-based solutions. Our principal compression software products are described below.

- *WSQ by Aware* compresses digital fingerprint data for use by law enforcement agencies such as the Federal Bureau of Investigation.
- Our electronic ID product suite includes *NistPack by Aware, Sequence Check by Aware, CJIS Web by Aware, Accuprint by Aware, and Accuscan by Aware.* These products are used by law enforcement agencies to format, edit, validate, store, and print fingerprint and facial images.
- *JPEG 2000 Codec by Aware* provides a solution for the compression and decompression of still images using the high-quality, wavelet-based method defined by the JPEG 2000 standard.
- We also license radiology compression software, which compresses digital radiographs and other types of medical imagery.

Research and Development

Semiconductor intellectual property markets are characterized by rapid technological changes and advances. Accordingly, we make substantial investments in the design and development of new technologies, and for significant improvement of existing technologies. Our research and development activities are focused on the further development of our ADSL technology, including incorporating new industry standards that we expect will be adopted. We have also announced that we are developing technology for diagnostics and testing (Dr. DSL), G.SHDSL (ITU standard G.991.2), and wireless local area networking.

As of December 31, 2003, we had an engineering staff of 80 employees, representing 72% of our total employee staff. During the years ended December 31, 2003, 2002, and 2001, research and development expenses charged to operations were $12.1 million, $14.0 million, and $10.1 million, respectively. In addition, because our license agreements often call for us to provide engineering development services to our customers, a portion of our total engineering costs has been allocated to cost of contract revenue. We expect that we will continue to invest substantial funds in research and development activities.

Sales and Marketing

Our principal sales and marketing strategy is to license our ADSL intellectual property to semiconductor manufacturers. We believe that decisions involving the selection of our technology are frequently made at senior levels within a prospective customer's organization. Consequently, we rely significantly on presentations by our senior management to key employees at prospective customers. As of December 31, 2003, we had twelve people in our broadband sales and marketing organization.

Customers who have licensed our ADSL technology include ADI, Agere Systems, Inc. ("Agere"), Infineon, Intel, Legerity, Inc. (formerly Advanced Micro Devices' Communication Products Division), NEC Corporation, ST Microelectronics ("ST"), Metanoia Technologies (formerly a division of Sigmatel, Inc.), and 3COM/US Robotics.

In 2003, we derived approximately 27%, 17%, and 14% of our total revenue from ADI, Infineon, and Spirent Communications of Rockville, Inc. ("Spirent"), respectively. In 2002, we derived approximately 32%, 15%, and 12% of our total revenue from ADI, Infineon, and Intel, respectively. In 2001, we derived approximately 52% and 14% of our total revenue from ADI and Intel, respectively. All revenue in 2003, 2002, and 2001 was derived from unaffiliated customers.

We sell our software-based compression products primarily through OEMs and systems integrators. As of December 31, 2003, there were three people in our compression software sales organization.

Competition

We compete by offering comprehensive packages of standards-based, complex, system-level, broadband technology. Our success as an intellectual property supplier depends on the willingness and ability of semiconductor manufacturers to design, build and sell integrated circuits based on our intellectual property. The semiconductor industry is intensely competitive and has been characterized by:

- rapid price erosion;
- rapid technological change;
- short product life cycles;
- cyclical market patterns; and
- increasing foreign and domestic competition.

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

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

ADSL services compete with alternative DSL technologies that can also transport high-speed data over telephone lines. These technologies include symmetric high speed DSL (also known as HDSL, SDSL and G.SHDSL), and very high speed DSL, also known as VDSL. We cannot give you assurances that these alternative broadband technologies will not be more successful than ADSL or that we will be able to participate in markets involving these alternative broadband technologies.

ADSL services also compete with broadband technologies that use other network architectures to provide high-speed data service. These technologies include cable modems using cable networks, and wireless solutions using wireless networks. To date, ADSL services have been more successful than high-speed cable services outside of the United States; however cable services serve a larger number of broadband subscribers than ADSL inside the United States. We cannot give you assurances that these alternative network architectures will not be more successful than ADSL.

Many of our current and prospective ADSL licensees, as well as chipset competitors that compete with our semiconductor licensees, including Broadcom, Conexant, ST and TI, have significantly greater financial, technological, manufacturing, marketing and personnel resources than we do. We cannot give you assurances that we will be able to compete successfully or that competitive pressures will not seriously harm our business.

The markets for our wavelet image compression technology are competitive, and are expected to become increasingly more competitive in the near future.

Patents and Intellectual Property

We rely on a combination of nondisclosure agreements and other contractual provisions, as well as patent, trademark, trade secret and copyright law to protect our proprietary rights. We have an active program to protect our proprietary technology through the filing of patents. As of December 31, 2003, we had 23 issued patents and 49 pending patent applications pertaining to telecommunications and signal processing technology. We also had 12 issued patents and 5 pending patent applications pertaining to image compression, video compression, audio compression, seismic data compression and optical applications.

Although we have patented certain aspects of our technology, we rely primarily on trade secrets to protect our intellectual property. We attempt to protect our trade secrets and other proprietary information through agreements with our licensees, suppliers, employees and consultants, and through security measures. Each of our employees is required to sign a non-disclosure and non-competition agreement. Although we intend to protect our rights vigorously, we cannot assure you that these measures will be successful. In addition, effective intellectual property protection may be unavailable or limited in certain foreign countries.

Third parties may assert exclusive patent, copyright and other intellectual property rights to technologies that are important to us. In the past, we have received letters from third parties suggesting that we may be obligated to license such intellectual property rights. If we were found to have infringed any third party's patents, we could be subject to substantial damages and an injunction preventing us from conducting our business.

Manufacturing

Sales of hardware products constitute a relatively small portion of our total revenue. Since our primary strategic focus is IP licensing, we do not intend to produce hardware products in any material quantity for the foreseeable future. Consequently, we rely on third party contract manufacturers to assemble and test substantially all of our products. Our internal manufacturing capacity is limited to final test and assembly of certain products. Other than ADSL chipsets, which are available from ADI, we believe that other components for our equipment-based products are available from a number of suppliers.

Employees

At December 31, 2003, we employed 111 people, including 80 in engineering, 15 in sales and marketing, 3 in manufacturing and 13 in finance and administration. Of these employees, 109 were based in Massachusetts. None of our employees is represented by a labor union. We consider our employee relations to be good.

We believe that our future success will depend in large part on the service of our technical and senior management personnel and upon our ability to retain highly qualified technical, sales and marketing and managerial personnel. We cannot assure you that we will be able to retain our key managerial and technical employees or that we will be able to attract and retain additional highly qualified personnel in the future.

ITEM 2. PROPERTIES

We believe that our existing facilities are adequate for our current needs and that additional space sufficient to meet our needs for the foreseeable future will be available on reasonable terms. We currently occupy:

1. 72,000 square feet of office space in Bedford, Massachusetts, which serves as our headquarters. This site is used for our research and development, sales and marketing, and administrative activities. We own this facility.

2. 1,265 square feet of research and development space in Lafayette, California. This facility is currently leased for a 3-year term, which expires on August 31, 2004.

ITEM 3. 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter ended December 31, 2003.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is the only class of stock we have outstanding, and it trades on the Nasdaq National Market under the symbol AWRE. The following table sets forth the high and the low sales prices of our common stock as reported on the Nasdaq National Market from January 1, 2002 to December 31, 2003.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2003				
High	$2.48	$2.75	$3.29	$4.06
Low	1.60	1.62	1.98	2.73
2002				
High	$9.79	$6.50	$3.94	$3.05
Low	5.92	3.25	1.95	2.01

As of March 2, 2004, we had approximately 169 shareholders of record. This number does not include shareholders from whom shares were held in a "nominee" or "street" name. We have never paid cash dividends on our common stock and we anticipate that we will continue to reinvest any earnings to finance future operations.

We did not sell any equity securities that were not registered under the Securities Act of 1933 during the three months ended December 31, 2003.

ITEM 6. SELECTED FINANCIAL DATA

In the table below, we provide you with our selected consolidated financial data. We have prepared this information using our audited financial statements for the years ended December 31, 2003, 2002, 2001, 2000, and 1999. When you read this selected financial data, it is important that you read it along with Management's Discussion and Analysis of Financial Condition and Results of Operations, our historical consolidated financial statements, and the related notes to the financial statements, which can be found in Item 8.

Year ended December 31,	2003	2002	2001	2000	1999
	(in thousands, except per share data)				
Statements of Operations Data					
Revenue	$10,843	$13,844	$18,547	$30,667	$20,527
Income (loss) from operations	(8,635)	(12,529)	(4,823)	9,490	3,321
Cumulative effect of change in accounting principle (1)	-	-	-	(1,618)	-
Net income (loss)	(8,038)	(18,728)	(2,520)	13,414	4,898
Net income (loss) per share – basic	($0.35)	($0.83)	($0.11)	$0.60	$0.23
Net income (loss) per share – diluted	($0.35)	($0.83)	($0.11)	$0.56	$0.21
Balance Sheet Data					
Cash and short-term investments	$35,051	$33,302	$57,284	$57,503	$36,265
Working capital	36,727	33,481	59,608	67,146	41,348
Total assets	51,024	59,237	78,103	81,450	54,482
Total liabilities	1,384	1,659	1,947	3,117	1,514
Total stockholders' equity	49,640	57,578	76,156	78,333	52,968

(1) Effective January 1, 2000, we adopted Securities and Exchange Commission Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB 101") and recorded the impact in 2000. In 1999, the pro forma effect of retroactive application of SAB 101 would have resulted in net income of $3.280 million and net income per share, basic and diluted, of $0.15 and $0.14, respectively.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

The following table sets forth, for the years indicated, certain line items from our consolidated statements of operations stated as a percentage of total revenue:

	Year ended December 31,		
	2003	2002	2001
Revenue:			
Product sales	40 %	33 %	21 %
Contract revenue	26	49	44
Royalties	34	18	35
Total revenue	100	100	100
Costs and expenses:			
Cost of product sales	10	7	3
Cost of contract revenue	14	35	37
Research and development	111	101	54
Selling and marketing	22	21	16
General and administrative	22	26	16
Total costs and expenses	179	190	126
Loss from operations	(79)	(90)	(26)
Interest income	5	6	12
Loss before provision for income taxes	(74)	(84)	(14)
Provision for income taxes	-	(51)	-
Net loss	(74) %	(135) %	(14) %

Product Sales

Product sales consist primarily of revenue from the sale of hardware products and compression software. Hardware products primarily include ADSL test and development systems, modules, and modems. Compression software consists of standard off-the-shelf software products that are sold to OEM customers that integrate our software into their equipment-based products.

Product sales decreased 5% from $4.5 million in 2002 to $4.3 million in 2003. As a percentage of total revenue, product sales increased from 33% in 2002 to 40% in 2003. The dollar decrease was primarily due to a decrease in revenue from the sale of compression software and to a lesser extent lower revenue from the sale of test and development systems, which was partially offset by an increase in revenue from the sales of modules. Compression software revenue decreased primarily due to lower sales of our electronic identification products. Test and development system revenue decreased primarily due to lower demand from our semiconductor and equipment customers. Module sales were higher primarily due to sales to a customer that is using them in ADSL test equipment.

Product sales increased 19% from $3.8 million in 2001 to $4.5 million in 2002. As a percentage of total revenue, product sales increased from 21% in 2001 to 33% in 2002. The dollar increase was primarily due to higher unit volume sales of modules and compression software, which was partially offset by a decrease in revenue from the sale of test and development systems. Module sales were higher primarily due to sales to a customer that is using them in ADSL test equipment. Compression software revenue increased primarily due to higher demand for our electronic identification products. Test and development system revenue decreased primarily due to lower demand from our semiconductor and equipment customers, which was the result of continued difficult economic conditions in the semiconductor and telecommunications industries.

Contract Revenue

Contract revenue consists primarily of license and engineering service fees that we receive under agreements with our customers to develop ADSL chipsets.

Contract revenue decreased 58% from $6.8 million in 2002 to $2.8 million in 2003. As a percentage of total revenue, contract revenue decreased from 49% in 2002 to 26% in 2003. Contract revenue decreased 18% from $8.3 million in 2001 to $6.8 million in 2002. As a percentage of total revenue, contract revenue increased from 44% in 2001 to 49% in 2002.

The dollar decreases in contract revenue in 2003 and 2002 were primarily due to a difficult environment for licensing intellectual property for communications integrated circuits. Both existing and prospective ADSL chipset licensees were reluctant to begin new development projects given: (i) generally weak worldwide economic conditions, (ii) a difficult and uncertain environment in the semiconductor and telecommunications industries, and (iii) intense ADSL chipset competition and falling chipset prices. During the last several years, customers and potential customers cautiously evaluated new chipset projects or delayed or cancelled projects in the face of such conditions. We are uncertain when the economic and market conditions we faced over the last several years will improve.

On our February 5, 2004 earnings release conference call, we referred to new customers and new chipset development projects. One of these new customers signed a contract in the fourth quarter of 2003. The contract requires the customer to pay us license and service fees based upon the license of our ADSL technology and provision of engineering services as well as royalty payments for sales of the customer's ADSL chipsets that are based on our licensed technology. Based on our performance under the contract, we recorded $0.2 million as revenue in our earnings release dated February 5, 2004 announcing results for the fourth quarter of 2003.

Subsequent to the earnings release and conference call, the customer expressed a desire to terminate the contract because of a management change and a subsequent decision to withdraw from the ADSL business. The customer does not have this termination right and we are in discussions with the customer to attempt to resolve the matter. Since this dispute created uncertainty regarding whether the collectibility of the related receivable of $0.2 million is reasonably assured, our financial statements reflect a reduction in revenue for the fourth quarter of 2003 to $3.0 million, and revenue for the full year to $10.8 million as compared to amounts reported in our earnings release. There are corresponding increases in loss from operations, loss before provision for income taxes and net loss and an increase in our reported loss per share for the fourth quarter of 2003 from $0.06 to $0.07.

Royalties

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

Royalties increased 47% from $2.5 million in 2002 to $3.7 million in 2003. As a percentage of total revenue, royalties increased from 18% in 2002 to 34% in 2003. The increase in royalties was primarily due to an increase in ADSL chipset sales by our largest customer ADI and to a lesser extent by Infineon. Despite the increase in ADSL chipset sales by ADI over the last year, ADI's chipset sales have declined in previous years primarily due to falling ADSL chipset pricing and lower ADI sales volumes. Despite steady growth of worldwide ADSL subscribers over the last several years, the availability of ADSL chipsets from a number of suppliers and intense competition among those suppliers has caused chipset prices to drop sharply. Additionally, deployments of ADSL service in geographic areas where chipsets based upon our technology have been sold leveled off or declined. We are uncertain when ADSL chipset pricing will improve, whether ADI will be able to continue to grow its presence or whether our other licensees will contribute meaningful royalty revenue.

In 2003, Infineon began increasing the number of ADSL chipsets it sells based upon our technology. Infineon has announced design wins with several telecommunications equipment suppliers, including Siemens AG and Alcatel Alsthom S.A., for chipsets that are based on our ADSL technology. We are uncertain how quickly sales of these chipsets will increase and whether they will contribute meaningful royalties to us.

Royalties decreased 61% from $6.5 million in 2001 to $2.5 million in 2002. As a percentage of total revenue, royalties decreased from 35% in 2001 to 18% in 2002. The decrease in royalties was primarily due to a decrease in ADSL chipset sales by our largest customer, ADI. We believe that ADI's chipset sales declined primarily due to falling ADSL chipset pricing and a potential loss of market share. Despite strong growth of worldwide ADSL subscribers in 2002, the availability of ADSL chipsets from a number of suppliers and intense competition among those suppliers has caused chipset prices to drop sharply over the last two years. Additionally, deployments of ADSL service in geographic areas where chipsets based upon our technology have been sold leveled off or declined in 2002.

Cost of Product Sales

Since the cost of compression software license sales is minimal, cost of product sales consists primarily of costs associated with ADSL hardware product sales. Cost of product sales were essentially the same at $1.0 million in 2002 and 2003. As a percentage of product sales, cost of product sales increased from 21% in 2002 to 24% in 2003. Although cost of product sales were essentially unchanged during 2003 and 2002, there were two offsetting factors that caused this result. Cost of product sales increased in 2003 primarily due to an increase in module sales. This increase was offset by a decrease in cost of product sales that was primarily due to lower sales of test and development systems. The decline in overall product margins was primarily due to a smaller proportion of compression software sales in the product sales revenue mix.

Cost of product sales increased 52% from $0.6 million in 2001 to $1.0 million in 2002. As a percentage of product sales, cost of product sales increased from 16% in 2001 to 21% in 2002. The increase in cost of product sales was primarily due to a greater proportion of module sales in the sales mix. Modules have higher cost of sales than the other products that comprise our product revenue.

Cost of Contract Revenue

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

Cost of contract revenue decreased 68% from $4.9 million in 2002 to $1.6 million in 2003. As a percentage of contract revenue, cost of contract revenue decreased from 72% in 2002 to 55% in 2003. The dollar and percentage decrease in cost of contract revenue was primarily due to the following factors: i) there were fewer customer contracts in contract revenue in 2003 as compared to 2002, so our cost of contract revenue declined as well; ii) in 2003, we began licensing a more technically mature intellectual property package that requires us to provide less engineering services to our customers; and iii) contract revenue in 2003 included a one-time contractual termination fee that had no cost of contract revenue associated with it.

Cost of contract revenue decreased 28% from $6.8 million in 2001 to $4.9 million in 2002. As a percentage of contract revenue, cost of contract revenue decreased from 83% in 2001 to 72% in 2002. The dollar decrease in cost of contract revenue in 2002 was primarily due to fewer customer contracts. Since our cost of contract revenue is based on the level of effort we expend on customer projects and the number of customer projects declined in 2002, cost of contract revenue declined as well.

Research and Development Expense

Research and development expense consists primarily of salaries for engineers and expenses for consultants, recruiting, supplies, equipment, depreciation and facilities related to engineering projects to enhance and extend our broadband intellectual property offerings, and our compression software technology. Research and development expense decreased 13% from $14.0 million in 2002 to $12.1 million in 2003. As a percentage of total revenue, research and development expense increased from 101% in 2002 to 111% in 2003. The dollar decrease was primarily due to a decrease of approximately $1.0 million per quarter in salaries and related expenses due to the reduction in force we implemented in October 2002 and salary reductions we imposed on January 1, 2003. This was partially offset by increased spending resulting from a shift of engineers from customer projects, where spending is classified as cost of contract revenue, to internal research and development projects, where spending is classified as research and development expense. This shift occurred because we had fewer customer projects in 2003 than in 2002, and we changed our technology offering such that it requires less engineering support by us. Our research and development spending was principally focused on projects related to core ADSL technology, including our StratiPHY™ chip, as well as for Dr. DSL®, G.SHDSL, wireless local area network communications, VDSL, and other development projects.

Research and development expense increased 38% from $10.1 million in 2001 to $14.0 million in 2002. As a percentage of total revenue, research and development expense increased from 54% in 2001 to 101% in 2002. The dollar increase in research and development spending was primarily due to the following factors:

(i) spending in 2002 includes the full year effect of a number of new engineers hired in 2001. Spending in 2001 only reflects that portion of the year that these employees were employed by us;
(ii) as the number of customer projects decreased over the past year, we shifted engineers who were working on these projects to internal research and development projects; and
(iii) we incurred additional research and development spending in 2002 to design and manufacture an ADSL/ADSL2 chip that we have named StratiPHY.

In October 2002, we terminated 35 employees to reduce our operating costs. Of the 35 employees who were terminated, 32 were engineers. The cost of severance and other employee benefits for terminated employees was approximately $700,000. The cost was recorded in the fourth quarter of 2002, and it approximates our historical quarterly costs for these employees as if they were active employees. Therefore, the reduction in force had a minimal effect on research and development spending in 2002. As of December 31, 2002, accrued severance costs were approximately $140,000, and were paid in the first half of 2003.

In connection with the October reduction in force, we informed remaining employees that effective January 1, 2003 their salaries would be reduced by 5% and that senior management's salaries would be reduced by 10%. We anticipate that the reduction in force and salary reductions will lower total 2003 engineering expenses by approximately $3.7 million annually, and will lower total 2003 company expenses by $4.1 million annually. Total engineering expenses include cost of contract revenue and research and development expense.

Selling and Marketing Expense

Selling and marketing expense consists primarily of salaries for sales and marketing personnel, travel, advertising and promotion, recruiting, and facilities expense. Sales and marketing expense decreased 19% from $3.0 million in 2002 to $2.4 million in 2003. As a percentage of total revenue, sales and marketing expense increased from 21% in 2002 to 22% in 2003. The dollar decrease was primarily due to lower spending on sales staff and to a lesser extent lower sales commissions and tradeshow expenses. Lower spending on sales staff was primarily due to the reduction in force and salary reductions we implemented in October 2002 and January 2003, respectively. The reduction in force and salary reductions lowered sales and marketing expenses by approximately $0.2 million in 2003.

Sales and marketing expense increased 2% from $2.9 million in 2001 to $3.0 million in 2002. As a percentage of total revenue, sales and marketing expense increased from 16% in 2001 to 21% in 2002. The dollar increase was primarily due to increased spending on sales staff and higher commissions for product sales, which was partially offset by lower advertising and tradeshow expenses.

General and Administrative Expense

General and administrative expense consists primarily of salaries for administrative personnel, facilities costs, and public company, bad debt, legal, and audit expenses. General and administrative expense decreased 34% from $3.6 million in 2002 to $2.4 million in 2003. As a percentage of total revenue, general and administrative expense decreased from 26% in 2002 to 22% in 2003. The dollar decrease was primarily due to a reduction in our provisions for bad debts and to lesser extent lower public company expenses, as well as the reduction in force and salary reductions we implemented in October 2002 and January 2003, respectively. The reduction in force and salary reductions lowered general and administrative expenses by approximately $0.2 million in 2003.

General and administrative expense increased 24% from $2.9 million in 2001 to $3.6 million in 2002. As a percentage of total revenue, general and administrative expense increased from 16% in 2001 to 26% in 2002. The dollar increase was primarily due to higher provisions for bad debts. In the fourth quarter of 2002, we increased our allowance for doubtful accounts by $0.7 million for an accounts receivable balance that we considered uncollectible.

Interest Income

Interest income decreased 33% from $0.9 million in 2002 to $0.6 million in 2003. The dollar decrease was primarily due to lower interest rates earned on our cash balances and lower cash balances.

Interest income decreased 61% from $2.3 million in 2001 to $0.9 million in 2002. The dollar decrease was primarily due to lower interest rates earned on our cash balances and lower cash balances.

Income Taxes

We evaluate, on a quarterly basis, the positive and negative evidence affecting the realizability of our deferred tax assets. As a result of incurring operating losses since 2001, we determined that it is more likely than not that our deferred tax assets may not be realized, and since the fourth quarter of 2002 have established a full valuation allowance for our net deferred tax assets. Accordingly, we have not recorded a deferred tax benefit for the operating losses incurred in the year ended December 31, 2003.

In 2002, we determined that due to our continuing operating losses in 2001 and 2002 as well as the uncertainty of the timing of profitability in future periods, we should fully reserve our deferred tax assets. As a result, we recorded a tax provision of $7.1 million in 2002 to reserve for our remaining deferred tax assets. In 2001, we made no provision for income taxes because we had a net loss.

As of December 31, 2003, we had federal net operating loss and research and experimentation credit carryforwards of approximately $48.7 million and $8.8 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates through 2023. In addition, at December 31, 2003, we had approximately $41.0 million and $4.6 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates through 2023.

Of the total net operating loss and research and development tax credit carryforwards for which a valuation allowance was recorded, approximately $24.1 million is attributable to the exercise of stock options and the tax benefit will be credited to additional paid-in capital, if realized in the future.

LIQUIDITY AND CAPITAL RESOURCES

Since our inception in March 1986, we have financed our activities primarily through the sale of stock. In the years ended December 31, 2003, 2002 and 2001, we received net proceeds from the issuance of stock under employee stock plans of $0.1 million, $0.2 million and $0.3 million, respectively. Our operating activities used net cash of $8.1 million and $9.5 million in the years ended December 31, 2003 and 2002, respectively. Cash used in our operating activities was primarily the result of operating losses and working capital requirements. Operating activities provided net cash of $1.2 million in the year ended December 31, 2001. Cash provided by operations during 2001 was primarily due to the collection of accounts receivables, which was partially offset by a decrease in deferred revenue.

In the years ended December 31, 2003, 2002, and 2001, we made capital expenditures of $0.2 million, $0.8 million, and $1.4 million, respectively. Capital expenditures in all three years primarily consisted of spending on computer hardware and software, laboratory equipment, and furniture used principally in engineering activities. We have no material commitments for capital expenditures.

At December 31, 2003, we had cash, cash equivalents, short-term investments and investments of $39.0 million. While we can not assure you that we will not require additional financing, or that such financing will be available to us, we believe that our cash, cash equivalents, short-term investments and investments will be sufficient to fund our operations for at least the next twelve months.

To date, inflation has not had a material impact on our financial results. There can be no assurance, however, that inflation will not adversely affect our financial results in the future.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any financial partnerships with unconsolidated entities, such as entities often referred to as structured finance, special purpose entities or variable interest entities which are often established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Accordingly, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had such relationships.

CONTRACTUAL OBLIGATIONS

We have various contractual obligations impacting our liquidity. The following represents our contractual obligations as of December 31, 2003 (in thousands):

	Payments Due By Period				
Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating Leases	$ 30	$ 30	$-	$-	$-
Purchase orders	359	359	-	-	-
Total	$389	$389	$-	$-	$-

CRITICAL ACCOUNTING POLICIES

We consider certain accounting policies related to revenue recognition, income taxes and the allowance for doubtful accounts to be critical policies.

Revenue recognition. We derive our revenue from three sources (i) product revenue, which includes revenue from the sale of ADSL equipment and compression software products, (ii) contract revenue, which includes license and engineering service fees that we receive under customer agreements, and (iii) royalties that we receive under customer contracts.

As prescribed by Securities and Exchange Commission Staff Accounting Bulletin No. 104, Revenue Recognition, we recognize revenue when there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and delivery has occurred or services have been rendered. We also apply the principles set forth in AICPA Statement of Position No. 97-2, Software Revenue Recognition, when recognizing compression software revenue. Our revenue recognition policies are described more fully in Note 2, Summary of Significant Accounting Policies, in the Notes to our Consolidated Financial Statements.

As described below, we make significant judgments and estimates during the process of determining revenue for any particular accounting period.

In determining revenue recognition, we assess whether fees associated with revenue transactions are fixed or determinable and whether or not collection is reasonably assured. We make a judgment whether fees are fixed or determinable based on the payment terms associated with that transaction. We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

In addition to these general revenue recognition judgments, we make specific judgments and estimates with respect to the recognition of contract revenue. When our agreements include the transfer of technology and the provision of engineering services, we combine the total license and engineering service fees to be paid under the agreement. These total fees are recognized ratably over the expected product development period, subject to the limitation that the cumulative revenue recognized through the end of any period may not exceed cumulative contract payments to date. We review assumptions regarding the product development period on a regular basis and make adjustments as required. Consistent with the principles of SAB 104, we believe that this method represents the appropriate systematic method for revenue recognition for this type of contract.

After customers enter into development and license agreements, they often engage us to provide additional engineering work that is beyond the scope of their original base agreement. When customers request additional services, both parties agree to engineering fees that are based on the level of effort required. We recognize revenue from these agreements either as engineering services are performed or as milestones are achieved.

Income taxes. As part of the process of preparing our consolidated financial statements we are required to estimate our actual current tax expense. We must also estimate temporary and permanent differences that result from differing treatment of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent that we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period for deferred tax assets which have been recognized, we must include an expense with the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets, and any valuation allowance recorded against our net deferred tax assets. Our deferred tax assets relate to net operating losses and research and development tax credits that we are carrying forward into future tax periods. As of December 31, 2003, we had a total of $41.8 million of deferred tax assets for which we had recorded a full valuation allowance.

Of the total valuation allowance, approximately $24.1 million relates to net operating loss and research and development tax credit carryforwards that are attributable to the exercise of stock options and the tax benefit will be credited to additional paid-in capital, if realized in the future.

Allowance for doubtful accounts. We make judgments as to our ability to collect outstanding receivables and provide allowances for receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices. If the judgments we make to determine the allowance for doubtful accounts do not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be required.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2003, the SEC issued Staff Accounting Bulletin ("SAB") No. 104, Revenue Recognition, which supersedes SAB No. 101, Revenue Recognition in Financial Statements. SAB No. 104 rescinds accounting guidance in SAB No. 101 related to multiple-element arrangements as this guidance has been superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"). The adoption of SAB No. 104 did not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2003, FASB issued Statement of Financial Accounting Standards 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. For all financial instruments entered into or modified after May 31, 2003, SFAS 150 is effective immediately. For all other instruments, SFAS 150 goes into effect at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material impact on our financial position or results of operations.

In April 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This statement amends SFAS 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities and requires contracts with similar characteristics to be accounted for on a comparable basis. This statement was effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company adopted SFAS 149 on July 1, 2003 and the adoption did not have a material effect on its consolidated financial position or results of operations.

In January 2003, the FASB issued FASB Interpretation No. 46, as amended by FIN 46R, "Consolidation of Variable Interest Entities, an Interpretation of ARB 51" ("FIN 46"). The primary objectives of FIN 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities" or "VIEs") and how to determine when and which business enterprise should consolidate the VIE. This new model for consolidation applies to an entity which either: (a) the equity investors (if any) do not have a controlling financial interest; or (b) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. For VIEs created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period ending after March 15, 2004. The Company has not created or acquired any VIEs after January 31, 2003. The Company does not expect the adoption of FIN 46 to have a material impact on its financial position or results of operations.

In November 2002, the EITF reached a consensus on issue 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." EITF 00-21 addresses revenue recognition on arrangements encompassing multiple elements that are delivered at different points in time, defining criteria that must be met for elements to be considered to be a separate unit of accounting. If an element is determined to be a separate unit of accounting, the revenue for the element is recognized at the time of delivery. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company adopted EITF 00-21 on July 1, 2003 and the adoption did not have a material effect on its consolidated financial position or results of operations.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Some of the information in this Form 10-K contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as “may,” “will,” “expect,” “anticipate,” “believe,” “estimate,” “continue” and similar words. You should read statements that contain these words carefully because they: (1) discuss our future expectations; (2) contain projections of our future operating results or financial condition; or (3) state other “forward-looking” information. However, we may not be able to *predict future events accurately. The risk factors listed in this section, as well as any cautionary language in this Form 10-K, 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-K could materially and adversely affect our business. We assume no obligation to update any forward-looking statements.*

Our Quarterly Results are Unpredictable and May Fluctuate Significantly. Our quarterly revenue and operating results are difficult to predict and may fluctuate significantly from quarter to quarter. Because our revenue components fluctuate and are difficult to predict, and our expenses are largely independent of revenues in any particular period, it is difficult for us to accurately forecast revenues and profitability. We generally recognize contract revenues ratably over the period during which we expect to provide engineering services. While this means that contract revenues from current licenses are generally predictable, changes can be introduced by a reevaluation of the length of the development period, or by the termination of a contract. The initial estimate of this period is subject to revision as the product being developed under a contract nears completion, and a revision may result in an increase or decrease to the quarterly revenue for that contract. In addition, accurate prediction of revenues from new licensees is difficult because the development of a business relationship with a potential licensee is a lengthy process, frequently spanning a year or more, and the fiscal period in which a new license agreement will be entered into, if at all, and the financial terms of such an agreement are difficult to predict. Contract revenues also include fees for engineering services, which are dependent upon the varying level of assistance desired by licensees and, therefore, the revenue from these services is also difficult to predict.

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

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

- market acceptance of our broadband technologies by semiconductor companies;
- the extent and timing of new license transactions with semiconductor companies;
- changes in our and our licensees' development schedules and levels of expenditure on research and development;
- the loss of a strategic relationship or termination of a project by a licensee;
- equipment companies' acceptance of integrated circuits produced by our licensees;
- the loss by a licensee of a strategic relationship with an equipment company customer;
- announcements or introductions of new technologies or products by us or our competitors;
- delays or problems in the introduction or performance of enhancements or of future generations of our technology;
- delays in the adoption of new industry standards or changes in market perception of the value of new or existing standards;
- competitive pressures resulting in lower contract revenues or royalty rates;
- personnel changes, particularly those involving engineering and technical personnel;
- costs associated with protecting our intellectual property;
- the potential that licensees could fail to make payments under their current contracts;
- ADSL market-related issues, including:
    - lower ADSL chipset unit demand brought on by excess channel inventory; and
    - lower average selling prices for ADSL chipsets.

- regulatory developments; and
- general economic trends and other factors.

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

We Experienced Net Losses. We had a net loss during 2003, 2002 and 2001. We expect that we will have a net loss during the first quarter of 2004. We may continue to experience losses in the future if:

- the semiconductor and telecommunications markets do not recover from the downturn that began in 2001;
- our existing customers do not increase their revenues from sales of chipsets with our technology; or
- new and existing customers do not choose to license our intellectual property for new chipset products, or
- a profitable business does not emerge from our Dr. DSL efforts.

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

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

- we must typically undergo a lengthy and expensive process of building a relationship with a potential licensee before there is any assurance of a license agreement with such party;
- we must persuade semiconductor and equipment manufacturers with significant resources to rely on us for critical technology on an ongoing basis rather than trying to develop similar technology internally;
- we must persuade potential licensees to bear development costs associated with our technology applications and to make the necessary investment to successfully produce chipsets and products using our technology; and
- we must successfully transfer technical know-how to licensees.

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

Our business could be seriously harmed if:

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

There Has Been and May Continue to be an Oversupply of ADSL Chipsets, Which Has Caused Our Royalty Revenue to Decline. The royalties we receive are influenced by many of the risks faced by the ADSL market in general, including reduced average selling prices ("ASPs") for ADSL chipsets during periods of surplus. Since late 2000, the ADSL industry has experienced an oversupply of ADSL chipsets and central office equipment. Excessive inventory levels led to soft chipset demand, which in turn led to declining ASPs. As a result of the soft demand and declining ASPs for ADSL chipsets, our royalty revenue has decreased substantially from the levels we achieved in 2000. Price decreases for ADSL chipsets, and the corresponding decreases in per unit royalties received by us, can be sudden and dramatic. Pricing pressures may continue during the first quarter of 2004 and beyond. Our royalty revenue may continue to decline over the long term.

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

We Derive a Significant Amount of Revenue from One Customer. In 2001, 2002 and 2003, we derived 52%, 32% and 27%, respectively of our total revenue from ADI. ADI was the first customer to license ADSL technology from us in 1993, and their chipsets are the most mature implementations of our technology in the market. Our royalty revenues to date have been primarily due to sales of ADI chipsets that use our ADSL technology. Our royalty revenue in the near term is highly dependent upon ADI's ability to maintain its market share and pricing. The ADSL market has experienced significant price erosion, which has adversely affected ADI's ADSL revenue, which in turn has adversely affected our royalty revenue. To the extent that ADI has lost market share, or loses market share in the future, or experiences further price erosion in its ADSL chipsets, our royalty revenue could continue to decline.

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

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

- competition from other businesses in the same industry;
- market acceptance of its products;
- its engineering, sales and marketing, and management capabilities;
- technical challenges of developing its products unrelated to our technology; and
- its financial and other resources.

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

Our Success Requires Telephone Companies to Install ADSL Service in Volume. The success of our ADSL licensing business depends upon telephone companies installing ADSL service in significant volumes. Factors that affect the volume deployment of ADSL service include:

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

- the pricing of ADSL services by telephone companies;
- the quality of telephone companies' networks;
- government regulations; and
- the willingness of residential telephone customers to demand ADSL service in the face of competitive service offerings, such as cable modems.

If telephone companies do not install ADSL service in significant volumes, or if telephone companies install ADSL service based on other technology, our business will be seriously harmed.

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

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

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

Our technology, software or products may infringe the intellectual property rights of others. A large and increasing number of participants in the telecommunications and compression industries have applied for or obtained patents. Some of these patent holders have demonstrated a readiness to commence litigation based on allegations of patent and other intellectual property infringement. Third parties may assert patent, copyright and other intellectual property rights to technologies that are important to our business. In the past, we have received claims from other companies that our technology infringes their patent rights. Intellectual property rights can be uncertain and can involve complex legal and factual questions. We may infringe the proprietary rights of others, which could result in significant liability for us. If we were found to have infringed any third party's patents, we could be subject to substantial damages and an injunction preventing us from conducting our business.

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

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

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

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

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

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

ADSL services offered over copper telephone networks also compete with alternative broadband transmission technologies that use the telephone network as well as other network architectures. Alternative technologies for the telephone network include symmetric high speed DSL (also known as HDSL, SDSL and G.SHDSL), and very high speed DSL, also known as VDSL. These DSL technologies are based on techniques other than those used by ADSL to transport high-speed data over telephone lines. Alternative technologies that use other network architectures to provide high-speed data service include cable modems using cable networks, and wireless solutions using wireless networks. These alternative broadband technologies may be more successful than ADSL and we may not be able to participate in the markets involving these alternative technologies.

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

We Must Make Judgments in the Process of Preparing Our Financial Statements. We prepare our financial statements in accordance with generally accepted accounting principles and certain critical accounting polices that are relevant to our business. The application of these principles and policies requires us to make significant judgments and estimates. In the event that judgments and estimates we make are incorrect, we may have to change them, which could materially affect our financial position and results of operations.

Moreover, accounting standards have been subject to rapid change and evolving interpretations by accounting standards setting organizations over the past few years. The implementation of new standards requires us to interpret and apply them appropriately. If our current interpretations or applications are later found to be incorrect, our financial position and results of operations could be materially affected.

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

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

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

Our Business May Be Affected by Government Regulations. The extensive regulation of the telecommunications industry by federal, state and foreign regulatory agencies, including the Federal Communications Commission, and various state public utility and service commissions, could affect us through the effects of such regulation on our licensees and their customers. In addition, our business may also be affected by the imposition of certain tariffs, duties and other import restrictions on components that our customers obtain from non-domestic suppliers or by the imposition of export restrictions on products sold internationally and incorporating our technology. Changes in current or future laws or regulations, in the United States or elsewhere, could seriously harm our business.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

We do not use derivative financial instruments for speculative or trading purposes. As of December 31, 2003, we had invested $35.1 million in cash, cash equivalents and short-term investments that matured in twelve months or less. Due to the short duration of these financial instruments, we do not expect that an increase in interest rates would result in any material loss to our investment portfolio.

As of December 31, 2003, we had invested $3.9 million in long-term investments that matured in one to three years. These long-term securities are invested in high quality corporate securities and U.S. government securities. Despite the high quality of these securities, they may be subject to interest rate risk. This means that if interest rates increase, the principal amount of our investment would probably decline. A large increase in interest rates may cause a material loss to our long-term investments. The following table (dollars in thousands) presents hypothetical changes in the fair value of our long-term investments at December 31, 2003. The modeling technique measures the change in fair value arising from selected potential changes in interest rates. Movements in interest rates of plus or minus 50 basis points (BP) and 100 BP reflect immediate hypothetical shifts in the fair value of these investments.

	Valuation of securities given an interest rate decrease of		**No change in interest rates**	**Valuation of securities given an interest rate increase of**	
Type of security	**(100BP)**	**(50 BP)**		**100 BP**	**50 BP**
Long-term investments with maturities of one to three years...	$3,995	$3,954	$3,913	$3,834	$3,874

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Index to Consolidated Financial Statements

The following consolidated financial statements of Aware, Inc. are filed as part of this Report on Form 10-K:

Consolidated Financial Statements:

Financial Statement Schedule:

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders of Aware, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Aware, Inc. and its subsidiary at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

Boston, Massachusetts
March 10, 2004

AWARE, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	December 31,	
	2003	**2002**
ASSETS		
Current assets:		
Cash and cash equivalents	$19,504	$25,268
Short-term investments	15,547	8,034
Accounts receivable (less allowance for doubtful accounts of $927 in 2003 and $1,077 in 2002)	2,449	1,258
Inventories	48	50
Prepaid expenses and other current assets	563	530
Total current assets	38,111	35,140
Property and equipment, net	8,921	10,038
Investments	3,913	13,816
Other assets, net	79	243
Total assets	$51,024	$59,237
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$261	$274
Accrued expenses	136	213
Accrued compensation	439	965
Accrued professional	77	65
Deferred revenue	471	142
Total current liabilities	1,384	1,659
Commitments and contingent liabilities (Note 7)		
Stockholders' equity:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized, none outstanding	-	-
Common stock, $.01 par value; shares authorized, 70,000,000 in 2003 and 2002; issued and outstanding, 22,750,294 in 2003 and 22,698,171 in 2002	228	227
Additional paid-in capital	77,400	77,301
Retained earnings (accumulated deficit)	(27,988)	(19,950)
Total stockholders' equity	49,640	57,578
Total liabilities and stockholders' equity	$51,024	$59,237

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

AWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Years ended December 31,		
	2003	**2002**	**2001**
Revenue:			
Product sales	$4,309	$4,530	$3,817
Contract revenue	2,840	6,797	8,253
Royalties	3,694	2,517	6,477
Total revenue	10,843	13,844	18,547
Costs and expenses:			
Cost of product sales	1,043	955	629
Cost of contract revenue	1,567	4,889	6,822
Research and development	12,074	13,956	10,104
Selling and marketing	2,407	2,966	2,916
General and administrative	2,387	3,607	2,899
Total costs and expenses	19,478	26,373	23,370
Loss from operations	(8,635)	(12,529)	(4,823)
Interest income	597	894	2,303
Loss before provision for income taxes	(8,038)	(11,635)	(2,520)
Provision for income taxes	-	(7,093)	-
Net loss	($8,038)	($18,728)	($2,520)
Net loss per share – basic and diluted	($0.35)	($0.83)	($0.11)
Weighted average shares – basic and diluted	22,713	22,679	22,631

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

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

	Years ended December 31,		
	2003	**2002**	**2001**
Cash flows from operating activities:			
Net loss	($8,038)	($18,728)	($2,520)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,471	1,844	1,720
Provision for doubtful accounts	(150)	707	25
Increase (decrease) from changes in assets and liabilities:			
Accounts receivable	(1,041)	(582)	3,792
Inventories	2	232	(115)
Deferred tax assets	-	7,093	-
Prepaid expenses and other current assets	(33)	265	(495)
Accounts payable	(13)	(79)	(130)
Accrued expenses	(591)	(351)	429
Deferred revenue	329	142	(1,469)
Net cash provided by (used in) operating activities	(8,064)	(9,457)	1,237
Cash flows from investing activities:			
Purchases of property and equipment	(190)	(807)	(1,424)
Other assets	-	(52)	(375)
Net sales (purchases) of short-term investments	(7,513)	13,194	(15,387)
Net sales (purchases) of investments	9,903	(13,816)	-
Net cash provided by (used in) investing activities	2,200	(1,481)	(17,186)
Cash flows from financing activities:			
Proceeds from issuance of common stock	100	150	343
Net cash provided by financing activities	100	150	343
Decrease in cash and cash equivalents	(5,764)	(10,788)	(15,606)
Cash and cash equivalents, beginning of year	25,268	36,056	51,662
Cash and cash equivalents, end of year	$19,504	$25,268	$36,056

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

AWARE, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
	Shares	Amount			
Balance at December 31, 2000	22,606	$226	$76,809	$1,298	$78,333
Exercise of common stock options	24	-	180		180
Issuance of common stock under employee stock purchase plan	28	1	162		163
Net loss				(2,520)	(2,520)
Balance at December 31, 2001	22,658	227	77,151	(1,222)	76,156
Exercise of common stock options	10	-	63		63
Issuance of common stock under employee stock purchase plan	30	-	87		87
Net loss				(18,728)	(18,728)
Balance at December 31, 2002	22,698	227	77,301	(19,950)	57,578
Exercise of common stock options	3	-	10		10
Issuance of common stock under employee stock purchase plan	49	1	89		90
Net loss				(8,038)	(8,038)
Balance at December 31, 2003	22,750	$228	$77,400	($27,988)	$49,640

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

1. NATURE OF BUSINESS

We are a leader in the development and marketing of intellectual property for broadband communications. Our principal offering to date has been Asymmetric Digital Subscriber Line ("ADSL") technology for the telecommunications industry. ADSL enables telephone companies to use their existing copper telephone lines to offer broadband services. We have adopted an intellectual property business model in which we neither manufacture nor sell integrated circuits incorporating our technology. We license our broadband technology on a nonexclusive and worldwide basis to semiconductor companies that manufacture and sell products that incorporate our technology. Our licensees sell integrated circuits to equipment companies who incorporate those integrated circuits into their products. We also offer ADSL hardware products and image compression software products.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation - The consolidated financial statements include the accounts of Aware, Inc. and its subsidiary. All significant intercompany transactions have been eliminated.

Cash and Cash Equivalents **–** Cash and cash equivalents consist primarily of demand deposits, money market funds, commercial paper, and discount notes in highly liquid short-term instruments with original maturities of three months or less from the date of purchase and are stated at cost, which approximates market.

Investments - At December 31, 2003 and 2002, we categorized all securities as "available-for-sale," since we may liquidate these investments currently. In calculating realized gains and losses, cost is determined using specific identification. Unrealized gains and losses on available-for-sale securities are excluded from earnings and reported in a separate component of stockholders' equity. At December 31, 2003 and 2002, unrealized gains and losses were not material.

The amortized cost of securities, which approximates fair value, consists of the following at December 31, 2003 and 2002 (in thousands):

Short-term investments	2003	2002
Corporate debt securities	$ 1,393	$ 3,185
U.S. agency securities	14,154	4,849
Total	$ 15,547	$ 8,034

Investments	2003	2002
Corporate debt securities	$1,709	$ 1,030
U.S. agency securities	2,204	12,786
Total	$3,913	$13,816

Short-term investments mature within three to twelve months, and investments mature within one to three years.

Allowance for Doubtful Accounts **–** Accounts are charged to the allowance for doubtful accounts as they are deemed uncollectible based on a periodic review of the accounts.

Inventories – Inventories are stated at the lower of cost or market with cost being determined by the first-in, first-out ("FIFO") method.

Property and Equipment – Property and equipment are stated at cost. Depreciation and amortization of property and equipment is provided using the straight-line method over the estimated useful lives of the assets. Upon retirement or sale, the costs of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the determination of income or loss. The estimated useful lives of assets used by us are:

Building and improvements	30 years
Building improvements	5 to 20 years
Furniture and fixtures and office equipment	5 years
Computer & manufacturing equipment	3 years
Purchased software	3 years

Impairment of Long-Lived Assets **–** We review long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value of the asset. If an impairment is indicated, the asset is written down to its estimated fair value on a discounted cash flow basis. The cash flow estimates used to determine the impairment, if any, reflect our best estimates using appropriate assumptions and projections at that time. We believe that no significant impairment of our long-lived assets has occurred as of December 31, 2003 and 2002.

Revenue Recognition. Effective January 1, 2000, we adopted Securities and Exchange Commission Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB 101"), which was superseded by SAB 104 effective December 2003 and was adopted by us at that time. Accordingly, our general revenue recognition policy is to recognize revenue when there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and delivery has occurred or services have been rendered.

We derive our revenue from three sources (i) product revenue, which includes revenue from the sale of ADSL equipment products and compression software products, (ii) contract revenue, which includes license and engineering service fees that we receive under customer agreements, and (iii) royalties that we receive under customer contracts. In addition to the above general revenue recognition principles prescribed by SAB 104, our specific revenue recognition policies for each revenue source are more fully described below.

Product sales. Product sales consist primarily of revenue from the sale of: (i) hardware products, and (ii) compression software.

- Hardware products, including ADSL transceiver modules and test and development systems are standalone products that are sold independently of our technology licensing business. The terms of sales generally do not contain provisions that obligate us to provide additional products or services after shipment. Additionally, we do not grant return rights other than normal warranty rights of return. We recognize revenue: (i) upon shipment when products are shipped FOB shipping point, and (ii) upon delivery at the customer's location when products are shipped FOB destination.

- Compression software consists of standard off-the-shelf software products that are sold to OEM customers that integrate our software into their equipment-based products. The terms of sale generally do not contain provisions that obligate us to provide additional products or services after shipment, other than technical telephone support for a brief period of time post sale. The cost of providing technical support is inconsequential because of the limited scope of the support. Additionally, we do not grant return rights other than normal warranty rights of return, and we generally do not customize software for customers. Occasionally, we sell maintenance contracts that entitle customers to product updates.

We recognize compression software revenue by applying the principles set forth in SAB 104 and American Institute of Certified Public Accountants ("AICPA") Statement of Position No. 97-2, Software Revenue Recognition. Accordingly, we recognize revenue for software licenses: (i) upon shipment when products are shipped FOB shipping point, and (ii) upon delivery at the customer's location when products are shipped FOB destination. We recognize revenue for maintenance contracts ratably over the related contract period.

Contract revenue. We enter into nonexclusive development and license agreements with semiconductor licensees that generally require us to make technology transfers and/or provide engineering services. In return, we receive one or more of the following forms of consideration: (i) license fees; (ii) engineering service fees; and (iii) royalty payments.

License fees or engineering services fees are typically paid and the revenue is recognized during the product development period as technology transfers are made or as engineering services milestones are achieved. Engineering milestones have historically been formulated to correlate with the estimated level of effort and related costs. Royalties are paid once a customer begins shipping products that incorporate our technology. We classify license and engineering service fees as contract revenue and we classify royalty payments as royalties.

When our agreements include both the transfer of technology and the provision of engineering services, we combine the total license and engineering service fees to be paid under the agreement. These total fees are recognized ratably over the expected product development period, subject to the limitation that the cumulative revenue recognized through the end of any period may not exceed cumulative contract payments to date. We review assumptions regarding the product development period on a regular basis and make adjustments as required. We believe that this method represents the appropriate systematic method for revenue recognition for this type of contract.

After customers enter into development and license agreements, they often engage us to provide additional engineering work that is beyond the scope of their original base agreement. When customers request additional services, both parties agree to engineering fees that are based on the level of effort required. We recognize revenue from these agreements either as engineering services are performed or as milestones are achieved.

Royalty revenue. Royalty revenue is generally recognized in the quarter in which a report is received from a licensee detailing the shipments of products incorporating our intellectual property components (i.e., in the quarter following the sales of the licensed product by the licensee). The terms of our licensing agreements generally require licensees to give notification to us and to pay royalties within 45 to 60 days of the end of the quarter during which sales of licensed products take place.

Income Taxes – We compute deferred income taxes based on the differences between the financial statement and tax basis of assets and liabilities using enacted rates in effect in the years in which the differences are expected to reverse. We establish a valuation allowance to offset temporary deductible differences, net operating loss carryforwards and tax credits when it is more likely than not that the deferred tax assets will not be realized.

Capitalization of Software Costs – We capitalize certain internally generated software development costs after technological feasibility of the product has been established. No software costs were capitalized for the years ended December 31, 2003, 2002 and 2001, because such costs incurred subsequent to the establishment of technological feasibility, but prior to commercial availability, were immaterial.

Concentration of Credit Risk – At December 31, 2003 and 2002, we had cash and investments, in excess of federally insured deposit limits of approximately $38.9 million and $47.0 million, respectively.

Concentration of credit risk with respect to net accounts receivable consists of $0.5 million, $0.5 million, and $0.4 million with three customers at December 31, 2003 and $0.6 million, $0.4 million, and $0.2 million with three customers at December 31, 2002.

Stock-Based Compensation – We grant stock options to our employees and directors. Such grants are for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. As permitted by SFAS No. 123, "Accounting for Stock-Based Compensation", we account for stock option grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44 ("FIN 44"), "Accounting for Certain Transactions Involving Stock Compensation." Accordingly, we have adopted the provisions of SFAS No. 123 through disclosure only.

At December 31, 2003, we have four stock-based employee compensation plans, which are described more fully in Note 6. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant. The following table illustrates the pro forma effect on net loss and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure – An Amendment of SFAS No. 123", to stock-based employee compensation (in thousands, except per share data):

	Year ended December 31,		
	2003	2002	2001
Net loss - as reported	($8,038)	($18,728)	($2,520)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	21,107	21,207	25,253
Net loss - pro forma	($29,145)	($39,935)	($27,773)
Basic loss per share – as reported	($0.35)	($0.83)	($0.11)
Basic loss per share – pro forma	($1.28)	($1.76)	($1.23)
Diluted loss per share – as reported	($0.35)	($0.83)	($0.11)
Diluted loss per share – pro forma	($1.28)	($1.76)	($1.23)

The fair value of options on their grant date was measured using the Black-Scholes option pricing model. Key assumptions used to apply this pricing model are as follows:

	Year ended December 31,		
	2003	2002	2001
Average risk-free interest rate	2.97%	3.82%	4.55%
Expected life of option grants	5 years	5 years	5 years
Expected volatility of underlying stock	95%	99%	104%
Expected dividend yield	-	-	-

Computation of Earnings per Share – Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing income available to common shareholders 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 antidilutive are excluded from the calculation.

Use of Estimates – The preparation of our financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Significant estimates include revenue recognition, reserves for doubtful accounts, reserves for excess and obsolete inventory, useful lives of fixed assets, valuation allowance for deferred income tax assets, and accrued liabilities. Actual results could differ from those estimates.

Fair Value of Financial Instruments – The carrying amounts of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses approximate fair value because of their short-term nature.

Comprehensive Income (Loss) - Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources, including foreign currency translation adjustments and unrealized gains and losses on marketable securities. For the years ended December 31, 2003, 2002 and 2001, comprehensive income (loss) was not materially different from net income (loss).

Advertising Costs – Advertising costs are expensed as incurred and were not material for 2003, 2002 and 2001.

Recent Accounting Pronouncements – In December 2003, the SEC issued Staff Accounting Bulletin ("SAB") No. 104, Revenue Recognition, which supersedes SAB No. 101, Revenue Recognition in Financial Statements. SAB No. 104 rescinds accounting guidance in SAB No. 101 related to multiple-element arrangements as this guidance has been superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"). The adoption of SAB No. 104 did not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2003, FASB issued Statement of Financial Accounting Standards 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. For all financial instruments entered into or modified after May 31, 2003, SFAS 150 is effective immediately. For all other instruments, SFAS 150 goes into effect at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material impact on our financial position or results of operations.

In April 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This statement amends SFAS 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities and requires contracts with similar characteristics to be accounted for on a comparable basis. This statement was effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company adopted SFAS 149 on July 1, 2003 and the adoption did not have a material effect on its consolidated financial position or results of operations.

In January 2003, the FASB issued FASB Interpretation No. 46, as amended by FIN 46R, "Consolidation of Variable Interest Entities, an Interpretation of ARB 51" ("FIN 46"). The primary objectives of FIN 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities" or "VIEs") and how to determine when and which business enterprise should consolidate the VIE. This new model for consolidation applies to an entity which either: (a) the equity investors (if any) do not have a controlling financial interest; or (b) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. For VIEs created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period ending after March 15, 2004. The Company has not created or acquired any VIEs after January 31, 2003. The Company does not expect the adoption of FIN 46 to have a material impact on its financial position or results of operations.

In November 2002, the EITF reached a consensus on issue 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." EITF 00-21 addresses revenue recognition on arrangements encompassing multiple elements that are delivered at different points in time, defining criteria that must be met for elements to be considered to be a separate unit of accounting. If an element is determined to be a separate unit of accounting, the revenue for the element is recognized at the time of delivery. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company adopted EITF 00-21 on July 1, 2003 and the adoption did not have a material effect on its consolidated financial position or results of operations.

***Segments* –** We organize ourselves as one segment reporting to the chief operating decision-maker. We have sales outside of the United States, which are described in Note 8. All long-lived assets are maintained in the United States.

3. INVENTORIES

Inventories consisted of the following at December 31 (in thousands):

	2003	2002
Raw materials	$48	$46
Finished goods	-	4
Total	$48	$50

4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following at December 31 (in thousands):

	2003	2002
Land	$1,080	$1,080
Building and improvements	8,837	8,784
Computer equipment	5,688	5,568
Purchased software	2,827	2,818
Furniture and fixtures	936	928
Office equipment	346	346
Manufacturing equipment	268	268
Total	19,982	19,792
Less accumulated depreciation and amortization	(11,061)	(9,754)
Property and equipment, net	$8,921	$10,038

Depreciation expense amounted to $1.3 million, $1.7 million and $1.7 million in each of the years ended December 31, 2003, 2002, and 2001, respectively.

5. INCOME TAXES

Deferred tax assets are attributable to the following at December 31 (in thousands):

	2003	2002
Federal net operating loss carryforwards	$16,560	$ 16,370
Research and development and other tax credit carryforwards	11,822	10,533
State net operating loss carryforwards	2,582	3,042
Capitalized research and development costs	9,872	6,932
Other	935	1,228
Total	41,771	38,105
Less valuation allowance	(41,771)	(38,105)
Deferred tax assets, net	$ -	$ -

A reconciliation of the U.S. federal statutory rate to the effective tax rate is as follows:

	Year ended December 31,		
	2003	2002	2001
Federal statutory rate	(34%)	(34%)	(34%)
State rate, net of federal benefit	(6)	(6)	(6)
Tax credits	(14)	(14)	(60)
Change in valuation allowance	50	111	100
Other	4	4	-
Effective tax rate	0%	61%	-%

During 2002, we recorded a valuation allowance of $38.1 million against all of our deferred tax assets. The valuation allowance was recorded against deferred tax assets because we determined that it was more likely than not that all of the deferred tax assets may not be realized. In 2003, we increased the valuation allowance by $3.7 million to $41.8 million primarily as a result of additional operating losses and tax credits.

We have incurred operating losses in 2003, 2002 and 2001. At December 31, 2003 and 2002, these cumulative factors resulted in our decision that it is more likely than not that all of our deferred tax assets may not be realized. If we generate sustained future taxable income against which these tax attributes may be applied, some portion or all of the valuation allowance would be reversed. If the valuation allowance is reversed approximately $24.1 million would be recorded as a credit to additional paid in capital reflecting the benefit of deductions from the exercise of stock options.

As of December 31, 2003, we had federal net operating loss and research and experimentation credit carryforwards of approximately $48.7 million and $8.8 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates through 2023. In addition, at December 31, 2003, we had approximately $41.0 million and $4.6 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates through 2023.

6. EQUITY AND STOCK COMPENSATION PLANS

At December 31, 2003, we have four stock-based compensation plans, which are described below.

Fixed Stock Option Plans – We have three fixed option plans. Under the 1990 Incentive and Nonstatutory Stock Option Plan (“1990 Plan”), we may grant incentive stock options or nonqualified stock options to our employees and directors for up to 2,873,002 shares of common stock. Under the 1996 Stock Option Plan (“1996 Plan”), we may grant incentive stock options or nonqualified stock options to our employees and directors for up to 6,100,000 shares of common stock. Under the 2001 Nonqualified Stock Plan (“2001 Plan”), we may grant nonqualified stock options to our employees and directors for up to 8,000,000 shares of common stock. Under all three plans, options are granted at an exercise price as determined by the Board of Directors; have a maximum term of ten years; and generally vest over three to five years. As of December 31, 2003, there were 6,242,964 shares available for grant under the 2001 Plan, 2,381,381 shares available for grant under the 1996 Plan, and no shares available under the 1990 Plan.

A summary of the transactions of our three fixed stock option plans for the years ended December 31, 2003, 2002, and 2001 are presented below:

	2003		2002		2001	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year...	6,842,546	$17.47	6,268,208	$20.63	4,083,683	$29.52
Granted	2,993,963	3.22	1,521,100	3.50	2,407,423	6.42
Exercised.......................................	(2,937)	3.54	(9,736)	6.48	(23,731)	7.60
Forfeited or cancelled	(6,365,643)	17.91	(937,026)	16.00	(199,167)	32.73
Outstanding at end of year.............	3,467,929	$4.38	6,842,546	$17.47	6,268,208	$20.63
Options exercisable at year end	2,356,254	$4.84	4,265,956	$21.01	3,358,403	$21.28

The weighted average grant date fair values of options granted during the years ended December 31, 2003 2002 and 2001 were $2.37, $2.65 and $5.01, respectively.

The following table summarizes information about stock options outstanding at December 31, 2003:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/03	Weighted-Avg. Remaining Contractual Life	Weighted-Avg. Exercise Price	Number Exercisable At 12/31/03	Weighted-Avg. Exercise Price
$0 to 5	3,204,854	9.7 years	$3.23	2,121,583	$3.27
5 to 10	110,916	7.3	$7.47	90,057	$7.55
10 to 20	56,409	3.8	$10.67	54,691	$10.66
20 to 30	22,250	6.8	$20.38	18,079	$20.38
30 to 40	45,000	5.5	$33.56	44,688	$33.56
40 to 50	18,500	6.2	$44.89	17,156	$44.67
50 to 70	10,000	5.8	$58.06	10,000	$58.06
	3,467,929	9.4	$4.38	2,356,254	$4.84

Employee Stock Purchase Plan - In June 1996, we adopted an Employee Stock Purchase Plan (the "ESPP Plan") under which eligible employees may purchase common stock at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or end of each six-month offering period. Participation in the ESPP Plan is limited to 6% of an employee's compensation, may be terminated at any time by the employee and automatically ends on termination of employment. A total of 350,000 shares of common stock have been reserved for issuance. As of December 31, 2003 there were 221,117 shares available for future issuance under the ESPP Plan. We issued 49,186, 30,694 and 27,733 common shares under the ESPP Plan in 2003, 2002 and 2001, respectively.

Stockholder Rights Plan - In October 2001, our board of directors adopted a stockholder rights plan and declared a dividend distribution of one share purchase right (a "Right") for each outstanding share of our common stock to stockholders of record at the close of business on October 15, 2001. Each share of common stock issued after that date also will carry with it one Right, subject to certain exceptions. Each Right, when it becomes exercisable, will entitle the record holder to purchase from us one ten-thousandth of a share of series A preferred stock at an exercise price of $40.00 subject to adjustment.

The Rights become exercisable upon the earliest of the following dates: (i) the date on which we first publicly announce that a person or group has become an acquiring person, or (ii) the date, if any, that our board of directors may designate following the commencement of, or first public disclosure of an intent to commence, a tender or exchange offer which could result in the potential buyer becoming a beneficial owner of 15% or more of our outstanding common stock. Under these circumstances, holders of Rights will be entitled to purchase, for the exercise price, the preferred stock equivalent of common stock having a market value of two times the exercise price. The Rights expire on October 2, 2011, and may be redeemed by us for $.001 per Right.

Employee Stock Option Exchange Program - On March 3, 2003, we commenced an offer to exchange outstanding stock options with eligible employees. Under the terms of the program, eligible employees had the right to tender for cancellation all stock options that they held with an exercise price above $3.00 per share by April 1, 2003. We accepted for exchange options to purchase an aggregate of 6,162,952 shares of our common stock. Subject to the terms and conditions of the offer, we were obligated to issue new options to purchase an aggregate of up to 3,081,563 shares of our common stock. On October 14, 2003, we granted options to purchase an aggregate of 2,854,213 shares of our common stock at the then current market value of $3.27 per share in connection with the offer to exchange. The replacement options were granted more than six months and one day after the cancellation of the old options. As a result, the new options were considered a fixed award and did not result in any compensation expense.

7. COMMITMENTS AND CONTINGENT LIABILITIES

Lease Commitments – We own our principal office and research facility in Bedford, Massachusetts, which we have occupied since November 1997. We conduct a portion of our activities in leased facilities in Lafayette, California under a non-cancellable operating lease that expires in 2004. The following is a schedule of future minimum rental payments (in thousands):

Year ended December 31,	
2004	$30
Total minimum lease payments	$30

Rental expense was approximately $45,000, $44,000 and $36,000 in 2003, 2002 and 2001, respectively.

Litigation - There are no material pending legal proceedings to which we are a party or to which any of our properties are subject which, either individually or in the aggregate, are expected to have a material adverse effect on our business, financial position or results of operations.

Guarantees and Indemnification Obligations – We enter into licensing agreements in the ordinary course of business that require us: i) to perform under the terms of the contracts, ii) to protect the confidentiality of our customers' intellectual property, and iii) to indemnify customers, including indemnification against third party claims alleging infringement of intellectual property rights. We also have agreements with each of our directors and executive officers to indemnify such directors or executive officers, to the extent legally permissible, against all liabilities reasonably incurred in connection with any action in which such individual may be involved by reason of such individual being or having been a director or officer of Aware.

Given the nature of the above obligations and agreements, we are unable to make a reasonable estimate of the maximum potential amount that we could be required to pay. Historically, we have not made any significant payments on the above guarantees and indemnifications and no amount has been accrued in the accompanying consolidated financial statements with respect to these guarantees and indemnifications.

8. BUSINESS SEGMENTS AND MAJOR CUSTOMERS

We manage the business as one segment and conduct our operations in the United States.

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

	Year ended December 31,		
	2003	2002	2001
United States	$8,049	$11,045	$17,092
Germany	1,990	2,271	570
Rest of world	804	528	885
	$10,843	$13,844	$18,547

The portion of total revenue that was derived from major customers was as follows:

	Year ended December 31,		
	2003	2002	2001
Customer A	27%	32%	52%
Customer B	17%	15%	2%
Customer C	14%	7%	3%
Customer D	9%	12%	14%

9. EMPLOYEE BENEFIT PLAN

In 1994, we established a qualified 401(k) Retirement Plan (the “Plan”) under which employees are allowed to contribute certain percentages of their pay, up to the maximum allowed under Section 401(k) of the Internal Revenue Code. Our contributions to the Plan are at the discretion of the Board of Directors. Our contributions were $284,000, $340,000 and $313,000 in 2003, 2002 and 2001, respectively.

10. NET INCOME (LOSS) PER SHARE

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

	Year ended December 31,		
	2003	2002	2001
Net income (loss)	($8,038)	($18,728)	($2,520)
Weighted average common shares outstanding	22,713	22,679	22,631
Additional dilutive common stock equivalents	-	-	-
Diluted shares outstanding	22,713	22,679	22,631
Net income (loss) per share – basic	($0.35)	($0.83)	($0.11)
Net income (loss) per share – diluted	($0.35)	($0.83)	($0.11)

For the years ended December 31, 2003, 2002 and 2001, potential common stock equivalents of 10,525, 226,303 and 285,427, respectively, were not included in the per share calculation for diluted EPS, because we had a net loss and the effect of their inclusion would be anti-dilutive. For the years ended December 31, 2003, 2002 and 2001, options to purchase 3,352,283, 4,770,052 and 3,488,215 shares of common stock at average weighted prices of $4.45, $23.54 and $31.95 per share, respectively, were outstanding, but were not included in the computation of diluted EPS because the options’ exercise prices were greater than the average market price of the common shares and thus would be anti-dilutive.

11. QUARTERLY RESULTS OF OPERATIONS - UNAUDITED

The following table presents unaudited quarterly operating results for each of our quarters in the two-year period ended December 31, 2003 (in thousands, except per share data):

	2003 Quarters Ended			
	March 31	June 30	September 30	December 31
Revenue	$1,947	$2,817	$3,055	$3,024
Loss from operations	(3,132)	(2,001)	(1,882)	(1,620)
Net loss	(2,963)	(1,844)	(1,746)	(1,485)
Net loss per share – basic	($0.13)	($0.08)	($0.08)	($0.07)
Net loss per share – diluted	($0.13)	($0.08)	($0.08)	($0.07)

	2002 Quarters Ended			
	March 31	June 30	September 30	December 31
Revenue	$3,576	$4,012	$3,953	$2,303
Loss from operations	(2,815)	(2,362)	(2,812)	(4,540)
Net loss	(2,576)	(2,130)	(9,681)	(4,341)
Net loss per share – basic	($0.11)	($0.09)	($0.43)	($0.19)
Net loss per share – diluted	($0.11)	($0.09)	($0.43)	($0.19)

FINANCIAL STATEMENT SCHEDULE

Schedule II - Valuation and Qualifying Accounts – Years ended December 31, 2003, 2002, and 2001
(in thousands)

Col. A	Col. B	Col. C (1)	Col. C (2)	Col. D	Col. E
		Additions			
	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions Charged to Reserves	Balance At End of Period
Allowance for doubtful accounts receivable:					
2003	$1,077	($150)	-	-	$927
2002	$380	$707	-	$10	$1,077
2001	$402	$25	-	$47	$380
Allowance for sales returns and allowances:					
2003	-	-	-	-	-
2002	-	-	-	-	-
2001	$125	-	($125)	-	-
Inventory reserves:					
2003	$284	-	-	-	$284
2002	$284	-	-	-	$284
2001	$209	$75	-	-	$284

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Our management, including our chief executive officer and chief financial officer, has evaluated our disclosure controls and procedures as of the end of the period covered by this Form 10-K and has concluded that our disclosure controls and procedures are effective. They also concluded that there were no changes in our internal control over financial reporting that occurred during the fourth quarter of 2003 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by Item 10 of Form 10-K is incorporated by reference from the information contained in the sections captioned *"Directors and Executive Officers"* and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement that will be delivered to our shareholders in connection with our May 27, 2004 Annual Meeting of Shareholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the section captioned *"Compensation of Directors and Executive Officers"* in the Proxy Statement that will be delivered to our shareholders in connection with our May 27, 2004 Annual Meeting of Shareholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 of Form 10-K is incorporated by reference from the information contained in the section captioned *"Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters"* in the Proxy Statement that will be delivered to our shareholders in connection with our May 27, 2004 Annual Meeting of Shareholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information, if any, required by Item 13 of Form 10-K is incorporated by reference from the information contained in the section captioned *"Certain Relationships and Related Transactions"* in the Proxy Statement that will be delivered to our shareholders in connection with our May 27, 2004 Annual Meeting of Shareholders.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated by reference from the information contained in the section captioned *"Independent Accountants"* in the Proxy Statement that will be delivered to our shareholders in connection with our May 27, 2004 Annual Meeting of Shareholders.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(A) See Item 8 for an index to the consolidated financial statements, supplementary financial information, and financial statement schedule.

Our chief executive officer and chief financial officer have furnished to the SEC the certification with respect to this Report that is required by Section 906 of the Sarbanes-Oxley Act of 2002.

(B) REPORTS ON 8-K

We filed a Form 8-K dated October 9, 2003, which included as an exhibit a press release dated October 9, 2003 announcing our financial results for the quarter ended September 30, 2003.

(C) INDEX TO EXHIBITS

Exhibits have been filed separately with the United States Securities and Exchange Commission in connection with this Annual Report on Form 10-K or have been incorporated into this Report by reference. Copies of such exhibits may be obtained from us upon request.

Exhibit No.	**Description of Exhibit**
3.1	Amended and Restated Articles of Organization (filed as Exhibit 3.2 to the Company's Registration Statement on Form S-1, File No. 333-6807 and incorporated herein by reference).
3.2	Articles of Amendment to the Articles of Organization (filed as Exhibit 3.3 to the Company's Form 10-Q for the quarter ended September 30, 2002 and incorporated herein by reference).
3.3	Amended and Restated By-Laws (filed as Exhibit 3.3 to the Company's Form 10-Q for the quarter ended June 30, 1996 and incorporated herein by reference).
4.1	Rights Agreement dated as of October 2, 2001 between Aware, Inc. and Equiserve Trust Company, N.A., as Rights Agent (filed as Exhibit 4(a) to the Company's Form 8-K filed with the Securities and Exchange Commission on October 3, 2001 and incorporated herein by reference).
4.2	Terms of Series A Participating Cumulative Preferred Stock of Aware, Inc. (attached as Exhibit A to the Rights Agreement filed as Exhibit 4.1 hereto).
4.3	Form of Right Certificate (attached as Exhibit B to the Rights Agreement filed as Exhibit 4.1 hereto).
10.1	1990 Incentive and Non-Statutory Stock Option Plan (filed as Exhibit 10.2 to the Company's Registration Statement on Form S-1, File No. 333-6807 and incorporated herein by reference).
10.2	1996 Stock Option Plan, as amended and restated (filed as Annex A to the Company's Definitive Proxy Statement filed with the Securities and Exchange Commission on April 11, 2000 and incorporated herein by reference).
10.3	1996 Employee Stock Purchase Plan, as amended and restated (filed as Annex A to the Company's Definitive Proxy Statement filed with the Securities and Exchange Commission on April 15, 2003 and incorporated herein by reference).
10.4	Form of Director and Officer Indemnification Agreement (filed as Exhibit 10.4 to the Company's Form 10-K for the year ended December 31, 2002 and incorporated herein by reference).
10.5	2001 Nonqualified Stock Plan (filed as Exhibit 99(d)(4) to the Company's Schedule TO filed with the Securities and Exchange Commission on March 3, 2003 and incorporated herein by reference).
21.1	Subsidiaries of Registrant.
23.1	Consent of PricewaterhouseCoopers LLP.

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

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

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

Date: March 15, 2004

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 15th day of March 2004.

Signature	Title
/s/ Michael A. Tzannes Michael A. Tzannes	Chief Executive Officer and Director (Principal Executive Officer)
/s/ Edmund C. Reiter Edmund C. Reiter	President and Director
/s/ David J. Martin David J. Martin	Interim Chief Financial Officer (Principal Financial and Accounting Officer)
/s/ John K. Kerr John K. Kerr	Chairman of the Board of Directors
/s/ David Ehreth David Ehreth	Director
/s/ G. David Forney, Jr. G. David Forney, Jr.	Director
/s/ Frederick D. D’Alessio Frederick D. D’Alessio	Director
/s/ Adrian F. Kruse Adrian F. Kruse	Director

Corporate Information

BOARD OF DIRECTORS

John K. Kerr
Chairman of the Board
Aware, Inc.

Michael A. Tzannes, Ph.D.
Chief Executive Officer
Aware, Inc.

Edmund C. Reiter, Ph.D.
President
Aware, Inc.

Frederick D. D'Alessio
General Partner
Capitol Management Partners

David Ehreth
Chairman of the Board
Westwave Communications, Inc.

G. David Forney, Jr., Sc.D.
Adjunct Professor, MIT
Vice President (retired),
Motorola, Inc.

Adrian F. Kruse, C.P.A., J.D.
Audit Partner (retired)
Ernst & Young LLP

OFFICERS

Michael A. Tzannes, Ph.D.
Chief Executive Officer

Edmund C. Reiter, Ph.D.
President

David J. Martin
Interim Chief Financial Officer

Richard W. Gross, Ph.D.
Senior Vice President
Engineering

LEGAL COUNSEL

Foley Hoag LLP
Boston, MA

INDEPENDENT ACCOUNTANTS

PricewaterhouseCoopers LLP
Boston, MA

TRANSFER AGENT

EquiServe Trust Company, NA
PO Box 219045
Kansas City, MO 64121-9045
www.equiserve.com

ANNUAL MEETING

Thursday, 10:00 a.m.
May 27, 2004
Renaissance Bedford Hotel
Bedford, MA

STOCK LISTING

NASDAQ: AWRE

CORPORATE HEADQUARTERS

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