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AWARE, INC.

ANNUAL REPORT 1998

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Few technological breakthroughs hold greater potential to enhance the lives of more people than the Internet. At Aware, we develop technology that enables the high-speed communications capabilities needed to transform the potential power of the Internet into a practical reality. This year's annual report provides details of four points we think you should know about our company – points that explain our expansive market opportunity, our innovative technology, the drivers behind high-speed Internet access service deployments, and our business strategy.

Dear Shareholder,

1998 was a breakthrough year for Aware in which a number of landmark events converged to create unprecedented momentum for the ADSL industry. The single most important event was the global acceptance of a new variant of ADSL, known as G.Lite or splitterless DSL, which transformed ADSL technology into a consumer-based, mass-market solution for high-speed Internet access.

In anticipation of this transformation, we redirected our company's focus in early 1998 and returned to our roots as a DSL technology provider. As an independent source of intellectual property and software, Aware is able to provide ADSL technology on a broad scale to a rapidly growing industry. By providing a wide range of ADSL technology offerings, including system architecture designs, application specific integrated circuit cores, run-time software, and reference designs, we enable our customers' success by complementing their technology, manufacturing and distribution strengths.

To capitalize on our technology leadership and continue growing our business, we must continue to proliferate our technology as widely as possible. The primary way in which we broaden the market for our technology is by playing a leading role at industry standard bodies and then rapidly offering technologies compliant with those standards. Our business model is to receive contract fees from our customers for co-developing chipsets and products with them. Upon completion of the developments, we receive royalty payments for each Aware DSL-enabled chipset or product that our customers sell. By strategically enhancing our already strong blue-chip customer list, and by leveraging the relationships our customers have with their customers, we expect that Aware's technology will be used in a significant percentage of DSL products and services over the next three years and that our royalty revenue will grow to represent more than 50% of our total revenue by 2001.

Three significant external events occurred in 1998 that clearly validated what we believed to be true: that Aware's technology will enable high-speed Internet access for consumers.

First, the International Telecommunications Union (ITU) relied upon important aspects of Aware's splitterless DSL-Lite technology in the determination of the new global industry standard for high-speed Internet access over telephone lines. Called G.Lite or G.992.2, this worldwide standard is expected to accelerate ADSL deployments by employing a simple plug-and-play approach to ADSL installation at the consumer's home and by enabling interoperability among the offerings of different ADSL equipment suppliers.

Second, the computer industry embraced the new G.Lite standard and quickly made it available in consumer products. Within a month of the ITU's announcement of the standard, Compaq Computer began shipping personal computers equipped with a new G.Lite modem that uses Aware's standard-compliant technology. These Compaq computers, which today include the Presario Internet PCs, are the world's first ADSL-equipped personal computers and represent a major step toward mass deployment of ADSL.

Third, telephone companies around the world, including Bell Atlantic, SBC Communications, BellSouth, US West, British Columbia Telephone, Deutsche Telekom, Telia, and Telecom New Zealand, began offering or have announced that they will be offering ADSL services to their respective customer bases. These worldwide service offerings will make ADSL services available to well over 25 million subscribers by the end of 1999.

Our relationships with leading semiconductor manufacturers and equipment suppliers also played a key role in the propagation of our technology in 1998. For example:

- Working with Lucent Microelectronics, we delivered Wildwire™, the first dual-mode chipset supporting both 56K and G.Lite-speed transmission, which is now being integrated into Compaq's Presario PCs.

- Together with Analog Devices, we shipped the first dual-mode, full-rate/G.Lite chipset family, including the AD20msp910 and '918 chipsets, which are already being widely used in ADSL trials and deployments around the world.

- With 3COM/US Robotics, we continue to develop modem products embedded with our technology.

- We demonstrated interoperability between Aware-based G.Lite chipsets from Lucent and Analog Devices – the first demonstration of its kind in the ADSL industry proving that solutions from different vendors can communicate at ultra-fast speeds.

- With Siemens Semiconductor Group, we made significant progress in developing a cost-effective chipset for upgrading central office switching and digital loop carrier (DLC) equipment from voice-only capable to "voice and data"-capable. Since every telephone line originates at central office or DLC equipment, the market for this voice/data chipset is truly enormous.

- Together with STMicroelectronics, the third largest manufacturer of telecom chipsets in the world, we are also developing a G.Lite chipset for telephone company switches.

One of our challenges going forward is to continue to be on the leading edge of ADSL technology development. Towards that goal, in 1998, we formed an important strategic relationship with Siemens ICN – the division of Siemens AG that produces the EWSD switch, the most widely sold switching system in the world. Aware and Siemens will architect the next generation of switching subsystems to enable high-speed data transmission as well as voice. Siemen's architecture will be based upon Aware's ADSL technology. These subsystems will be available for entirely new installations of central office linecards as well as for linecard upgrades to Siemens' existing installed base of 180 million lines around the world. While our relationships with Siemens Semiconductor Group and STMicroelectronics are focused on developing cost-optimized chipsets, our relationship with Siemens ICN is to develop ADSL technology that enables easy-to-install, easy-to-maintain equipment so that telephone companies can offer traditional voice as well as high-speed Internet access services.

Our 1998 financial performance provides evidence that our business strategy is working. After reaching "break-even" in the third quarter of 1998, the fourth quarter was our best quarter ever in terms of total revenue and profitability. 1998 revenue increased 90% to $11.8 million compared to $6.2 million in 1997. Our net loss for 1998 was $2.2 million or minus 11 cents per share, which compares to a net loss of $4.4 million or minus 23 cents per share for 1997.

Looking back on our achievements in 1998, we owe special thanks to our employees for their dedication, expertise, and outstanding contributions. On behalf of everyone at Aware, we also thank our customers and shareholders for their continued support.

Looking ahead, we believe Aware is well-positioned for substantial growth. Equipped with an innovative technology … faced with a mass-market opportunity … working with an effective business model … driven by the expertise of dedicated employees … and strengthened by an industry leading list of customers, we plan to build shareholder value by capitalizing on the rapid momentum currently underway in the ADSL market – while continuing to pioneer new breakthroughs in the area of high-speed access technology.

Sincerely,

Michael A. Tzannes
President and Chief Executive Officer

John K. Kerr
Chairman of the Board

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Opportunity
Leadership
Deployment
Growth

A Rapidly Growing Mass-Market Opportunity

The Internet is a wide world of opportunity for the consumer – and for Aware. Each day millions of people around the world log on to explore that world and to make it part of their own. Fascinated by the Internet's increasingly rich content, the total number of worldwide users is growing rapidly – from 110 million today, to a projected 478 million by 2005. At the same time, the Internet is continuously spawning new ways to enhance the lives of these users – from simple e-mail, to sophisticated telecommuting and videoconferencing, to convenient electronic shopping in never-before-possible virtual stores.

Until recently, high-speed access to the Internet has remained the single biggest challenge to unlocking its vast potential. Even today's fastest dial-up modems fail to deliver the high-speed communications capability or "broadband" needed for rapid access to this world. As a result, millions of frustrated consumers continually get caught in a cyberspace gridlock where data transmission slows to a crawl. This mass-market frustration has created enormous demand for high-speed Internet access.

Aware has developed breakthrough technologies targeted at enabling lightening-fast Internet access over the 750 million existing telephone lines in the world today thereby eliminating this frustrating gridlock. Aware's technologies effectively transform these very same phone lines into ultra high-speed broadband data pipes. For example, its full-rate ADSL technology enables consumers to download data 200 times faster than today's fastest dial-up modems. That's because it transmits data at speeds of up to 10 megabits per second over standard phone lines. What's more, Aware's new DSL-Lite technology replaces the need for a trained telephone technician to install ADSL equipment at every consumer's home with a simple plug-and-play modem – while still speeding data up to 30 times faster than the most advanced dial-up modem available.

While Aware's full-rate ADSL and DSL-Lite technologies are clearly breaking the speed barrier in Internet access, they also deliver a host of additional benefits. By enabling traditional voice to travel on the same line as high-speed data, for example, they eliminate busy signals and the need for a second phone line. By providing dedicated bandwidth, they deliver consistently high performance. And by enabling "always on" service, they eliminate the need to continually log on and off.

Aware's full-rate ADSL and DSL-Lite technologies position the company to meet the mass-market demand for high-speed Internet access head-on. While this demand is enormous today, the availability of high-speed Internet access using ADSL is expected to create an even bigger surge in market demand and enable a wealth of new content-rich Web applications. All of which should make the Internet an even greater world of opportunity in the future.

478 million

The number of Internet users around the world is expected to soar from 110 million today to a projected 478 million by 2005. (Ovum, Internet Market Forecast Report)

37% of U.S. households are now connected to the Internet.
(GartnerGroup's Dataquest, Personal Computing and Peripherals Group, January, 1999)

By 2002, 60% of the home on-line user population will be new users who were not on the net in 1998. (IDC)

According to Compaq, Internet access is now a leading reason why consumers purchase new PCs.

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Opportunity

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ADSL Technology Leadership

Aware is a leading provider of ADSL technology by a variety of measures.

Aware technology is being built into ADSL chipsets by some of the world's leading semiconductor companies. Consequently, more equipment companies – including telecommunications and networking equipment manufacturers, and modem and PC manufacturers – have announced that they are designing Aware technology into more products than that of any other ADSL technology provider.

Aware's ADSL leadership position is reinforced by its solid technological competitive edge. An early pioneer in the development of ultra high-speed transmission technology, Aware has been working on ADSL since 1993, and literally made history by inventing DSL-Lite in 1997. Today it offers multiple types of ADSL technology, holds numerous patents underlying its technology offerings, and has vast ADSL deployment experience. A key contributor to the new international standard for ADSL, Aware was the first company to integrate G.Lite technology into commercially available products.

Aware's technological edge has enabled the company to gain a strong first-to-market advantage. Its proven DSL technology has produced the world's first silicon-based chipsets for both full-rate ADSL and G.Lite – including unique, dual-mode G.Lite/Full-Rate ADSL and 56K/G.Lite versions. As a result, Aware believes it is well-positioned to maintain its leadership position as it further enhances and broadens its technology offerings.

With a clearly defined mission "to propagate and improve DSL technology" and two-thirds of its employees representing high-level engineering talent, Aware has both the strategic direction and the resources needed to increase its technological lead. The breadth and depth of Aware's technological expertise make it highly qualified to succeed in the ADSL marketplace.

one

Aware is the number one independent provider of full-rate ADSL and DSL-Lite technology.

"ADSL deployments have reached a turning point where a broader access to interoperable technology is necessary to drive the market. ADI and Aware have a leading technological edge, and by making our chipsets with Aware's underlying technology more readily available, we intend to solidify that position."
Russ Johnsen, vice president and general manager for communications, Analog Devices, Inc.

"Aware is a pioneer in splitterless DSL technology. That's why Lucent Microelectronics Group chose to incorporate Aware technology into our DSL-Lite products for PC manufacturers."
Bob Rango, general manager of new business initiatives, Lucent Microelectronics Group.

"Aware's outstanding ADSL experience and the very advanced stage of its DSL-Lite development adds high-performance and proven interoperability to our chipset."
Christian Wolff, vice president of Business Unit Analog Transceiver, Siemens Semiconductor.

Until recently, the lack of a single standard that would ensure interoperability among ADSL equipment at the consumer's home and the telephone company's central office has slowed the widespread deployment of ADSL technology.

In 1998, however, the International Telecommunications Union (ITU) adopted a global standard called G.Lite or G.992.2 which enables the development of interoperable ADSL equipment to support high-speed Internet access over regular phone lines. Aware's DSL-Lite technology is at the heart of this new international standard.

Spearheaded by PC, networking and telecommunications industry leaders, the new G.Lite standard overcomes two major hurdles that limited mass-market ADSL deployment in the past. First, it offers the telephone industry the promise of full compatibility among all ADSL equipment installed in its central offices and in consumers' homes. And second, it speeds ADSL deployment by replacing the high cost of sending a telephone company technician to install ADSL equipment at each consumer's home with a low-cost, do-it-yourself modem.

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Today, G.Lite modems incorporating Aware technology are commercially available, making fast Internet access on ADSL-enabled telephone lines as simple as plugging a phone into the wall. For example, Compaq's new Presario Internet PCs incorporate a Lucent Microelectronics' Wildwire™ modem chipset containing Aware's DSL-Lite technology. By the year 2000, Compaq has announced that it plans on having broadband capabilities in all its consumer PCs.

Driving the Deployment of ADSL Services

With the new standard enabling interoperability among ADSL equipment and the PC industry assuming responsibility for ADSL installation at the consumer's home, the telephone industry is empowered to compete more effectively with cable companies and emerge as the high-speed Internet access provider of choice among consumers.

Recognizing the opportunity to capture a significant share of this market by capitalizing on its existing $100 billion network of telephone lines that links virtually every home and business, the telephone industry is gearing up to deploy ADSL.

The line-up is impressive. In recent months, leading telephone companies around the world – from Bell Atlantic, SBC Communications, BellSouth and US West … to MCI WorldCom, GTE and Sprint … to BC Telecom and SingTel – have begun rolling out ADSL high-speed Internet access services for their consumers. Each of these deployments represents the potential of a mass-market opportunity for Aware. As momentum continues to build throughout the telephone industry, these new ADSL services are expected to begin significantly penetrating the mainstream consumer market by the end of 1999 – and we expect that Aware technology will be playing a key role.

4 to 1

Consumers interested in high-speed Internet access said they'd prefer to receive "DSL from a phone company" over "cable modem service from a cable company" by a margin of 4-to-1.

(Yankee Group, TAF survey, 1998)

Bell Atlantic has announced that it intends to roll out ADSL service in 353 central offices that serve 10 million customers by the end of 1999. Further, by the end of 2000, they intend to increase ADSL service offerings to 805 central offices serving 20 million customers.

SBC Communications has announced that it intends to roll out ADSL service in 526 central offices serving 9.5 million customers by the end of 1999.

Bell South has announced that it intends to make ADSL service available to 5 million customers by mid 1999.

We believe Aware is soundly positioned to benefit from the mass-market deployment of ADSL high-speed Internet access currently underway by the communication and PC industries. Understanding why requires a brief explanation of how Aware does business.

Aware licenses its ADSL technologies primarily to semiconductor companies, who embed its technologies into chipsets which are used in communications equipment for both the telecommunications industry and the consumer. Today, Aware's technology and software is being used by some of the world's largest semiconductor manufacturers. Its customers include Analog Devices, who sells ADSL chipsets to more than 50 equipment customers; Lucent Microelectronics, one of the largest sellers of chips for modem-equipped PCs in North America; Siemens Semiconductor, a leading worldwide chip manufacturer, 3COM/US Robotics, one of the largest sellers of modems in the world, and ST Microelectronics, the third largest telecommunications chipset provider in the world.

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Opportunity
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A Strategy Aimed at Leveraging High-Speed Internet Access Growth

Aware propagates its technologies by leveraging the global sales forces and customer bases of its semiconductor partners and of its partners' customers, who include leading networking, telecommunications and modem vendors. By so doing, Aware has gained a wide distribution channel, along with the freedom to focus on what it does best – technology development.

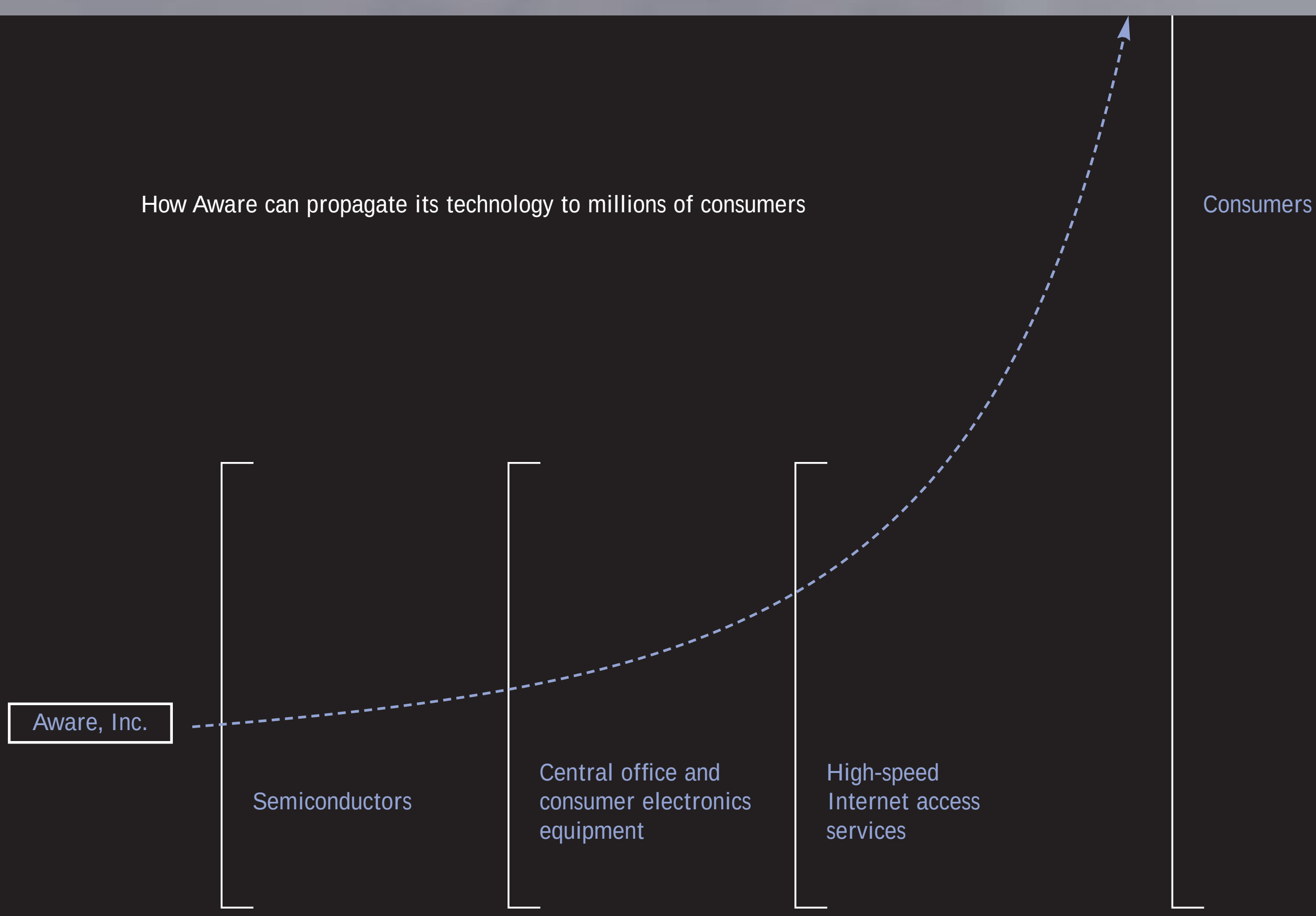
In addition to collecting licensing and engineering revenue from its customers during product development, Aware also collects "unit-based" royalty fees. This means that as Aware technology works its way through the deployment chain from the chipset to the consumer, it yields revenue on a "per chipset" basis. In other words, when consumers purchase or upgrade PCs or modems embedded with Aware ADSL technology (or a telephone company buys equipment based on Aware technology), Aware collects a royalty from its customers.

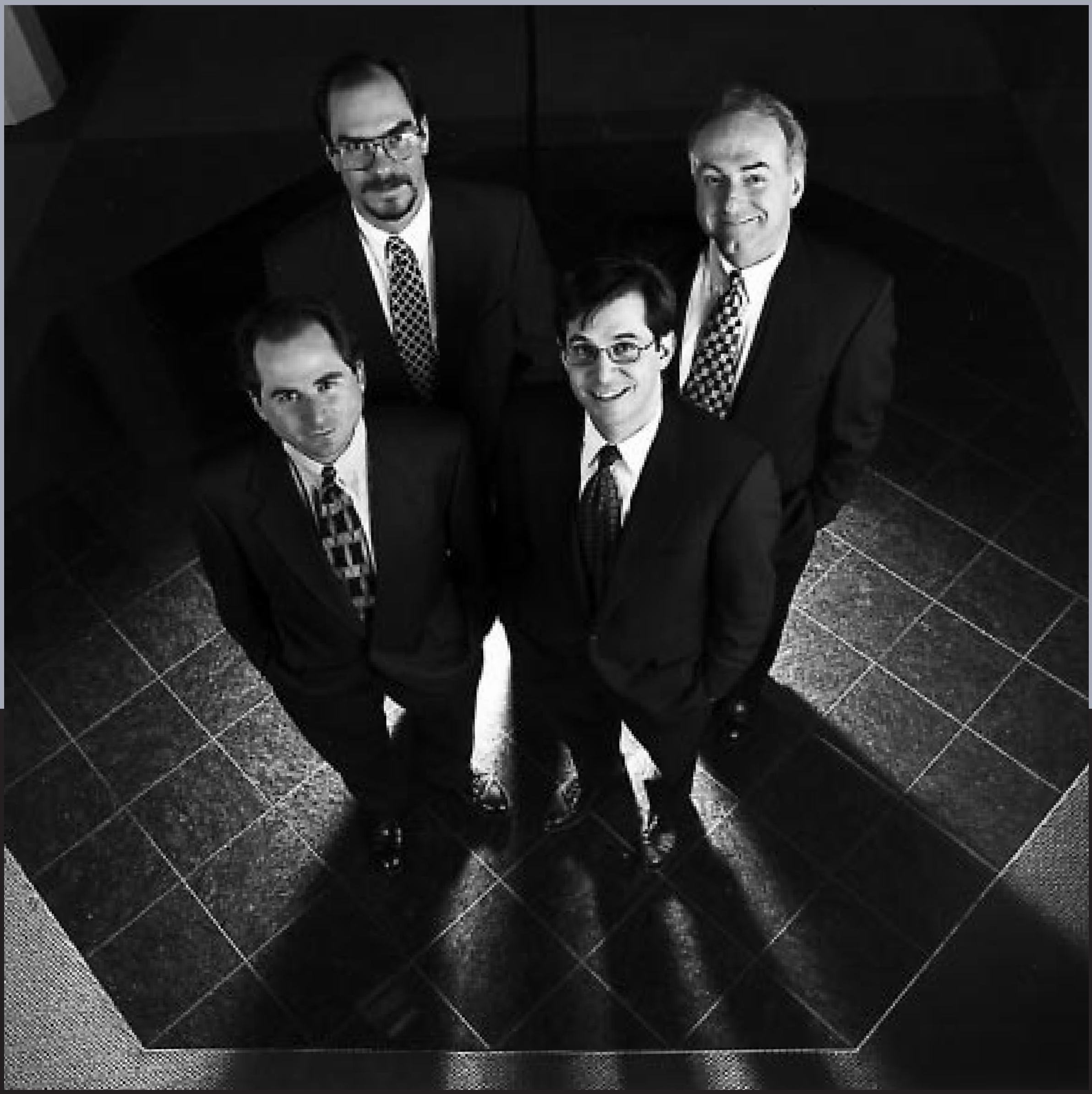
We believe that ADSL represents a new era in modem technology, one driven by high-speed Internet access products and services. And the future of high-speed data communications holds even more exciting possibilities. By continuing to enhance and broaden its breakthrough ADSL solutions and develop new innovations that continue to stretch the boundaries of the imagination, Aware plans to maintain its winning position in the race for ever-increasing high-speed data far into the future.

from one to millions

Aware propagates its technologies by leveraging the global sales forces and customer bases of its semiconductor partners and of its partners' customers. By doing so, Aware's technology can be made available to millions of consumers.

How Aware can propagate its technology to millions of consumers





Edmund C. Reiter
Senior Vice President

David C. Hunter
Executive Vice President
and Chief Operating Officer

Michael A. Tzannes
President and
Chief Executive Officer

Richard P. Moberg
Chief Financial Officer
and Treasurer

BOARD OF DIRECTORS

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Chairman of the Board
Aware, Inc.

Michael A. Tzannes
President and Chief Executive Officer
Aware, Inc.

David C. Hunter
Executive Vice President and
Chief Operating Officer
Aware, Inc.

David Ehreth
President
Westwave Communications

John S. Stafford
Member
Chicago Board of Options

OFFICERS

Michael A. Tzannes
President and Chief Executive Officer

David C. Hunter
Executive Vice President and
Chief Operating Officer

Richard P. Moberg
Chief Financial Officer and Treasurer

Edmund C. Reiter
Senior Vice President

LEGAL COUNSEL

Foley, Hoag & Eliot LLP
Boston, MA

INDEPENDENT ACCOUNTANTS

Deloitte & Touche LLP
Boston, MA

TRANSFER AGENT

EquiServe
150 Royall Street
Canton, MA 02021

ANNUAL MEETING

The annual meeting will be held at 10:00 a.m. on Tuesday, May 25, 1999 at the Bedford Renaissance Hotel in Bedford, MA

STOCK LISTING

The Company's common stock is traded on the Nasdaq National Market under the symbol AWRE.

STOCK PRICE HISTORY BY QUARTER

1998	First	Second	Third	Fourth
High	15 1/8	15 1/8	11 3/4	27 3/16
Low	10 7/16	10 1/4	4 3/4	4 3/4

1997	First	Second	Third	Fourth
High	14 7/8	16 7/8	15 1/8	14 15/16
Low	8 5/8	8 1/2	9 5/8	9 1/8

The preceding table sets forth the high and low sales prices as reported on the Nasdaq National Market from January 1, 1997 to December 31, 1998. As of February 19, 1999, the Company had approximately 156 shareholders of record. This number does not include shareholders for whom shares were held in a "nominee" or "street name." The Company has never paid cash dividends on its common stock and anticipates it will continue to reinvest any earnings to finance future operations.

CORPORATE HEADQUARTERS

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INVESTOR RELATIONS

For a copy of the Company's Form 10-K, additional copies of this report or other financial information, contact:
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AWARE

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SELECTED FINANCIAL DATA

(in 000's, except per share data)	Year Ended December 31, 1998	1997	1996	1995	1994
Statements of Operations Data					
Revenue	$ 11,796	$ 6,198	$ 5,301	$ 3,260	$ 3,827
Loss from operations	(3,951)	(6,157)	(538)	(454)	(1,095)
Net income (loss)	(2,249)	(4,448)	259	(343)	(1,012)
Net income (loss) per share – basic	($0.11)	($0.23)	$0.02	($0.29)	($0.88)
Net income (loss) per share – diluted	($0.11)	($0.23)	$0.01	($0.29)	($0.88)
Balance Sheet Data					
Cash and short-term investments	$ 26,567	$ 26,104	$ 36,719	$ 2,154	$ 2,566
Working capital	28,813	26,774	38,280	2,516	2,877
Total assets	40,162	39,281	40,123	3,228	3,930
Total liabilities	1,028	1,661	676	309	684
Total stockholders' equity	39,134	37,620	39,446	2,920	3,246

OVERVIEW

Aware, Inc. (the "Company") designs, develops, licenses and markets Digital Subscriber Line ("DSL") technology that enables high-speed Internet access over existing telephone networks. The Company licenses its intellectual property and software to semiconductor manufacturers and equipment manufacturers who sell chips and equipment incorporating Aware's technology. Aware also markets to equipment companies to encourage them to design Aware's technology into their products, and to service providers to encourage them to deploy new broadband services based on Aware's technology. The Company's technology includes intellectual property and software products such as patents, systems designs, semiconductor cores, run-time software, and hardware designs. The Company also offers hardware products, such as DSL development tools and customer premises equipment, as well as image compression software products.

OVERVIEW

From its incorporation in 1986 until 1993, Aware was primarily engaged in research, specializing in wavelet mathematics, digital compression, and telecommunications, including digital modulation and coding. In 1993, Aware shifted its business from contract research toward development and licensing of Digital Subscriber Line, or DSL, and other broadband technologies, as well as data and video compression software. Commencing in 1996 and 1997, Aware began to complement its DSL technology licensing and development activities by offering DSL products, including modems, access routers, transceiver modules and development systems. Aware's two principal objectives with respect to its product business were to demonstrate its DSL technology through its products, and to fill trial equipment opportunities until widespread deployment of DSL services began.

In the second quarter of 1998, Aware made a decision to focus primarily on licensing its intellectual property and software to semiconductor and equipment manufacturers that desire to vertically integrate Aware's technology to enable them to manufacture and sell integrated circuits incorporating Aware technology. Aware also markets its technology to (i) telecommunications and data communications equipment companies to encourage them to design Aware technology into their products, and (ii) service providers to encourage them to deploy services, such as highspeed Internet access, based on Aware technology. Additionally, Aware will continue to sell DSL development systems to support its technology licensing business, as well as sell software-based compression products.

Aware's decision to focus its strategic direction on intellectual property and software licensing was driven by the following factors: (i) consolidation within the industry among DSL technology providers created an opportunity for independent technology suppliers to fill a demand by semiconductor companies for such technology; (ii) Aware amended its agreement with Analog Devices, Inc. ("ADI") in March 1998 from an exclusive to a nonexclusive relationship, thus allowing Aware to license its technology to other semiconductor companies; (iii) Aware believes that its DSL intellectual property offers semiconductor companies valuable patent rights, time-to-market and risk reduction opportunities; and (iv) the entry of well-established companies with superior manufacturing and distribution capabilities increased pressure on DSL equipment pricing and caused Aware to conclude that there were other companies that could more competitively manufacture, distribute and support DSL equipment.

In the fourth quarter of 1998, the Company reclassified its revenue categories to reflect the change in its strategic direction and to improve the meaningfulness of its financial statement disclosure. Aware previously classified its revenue into product revenue, license and royalty revenue, and research and development revenue. Aware has reclassified its revenue into the following three line items:

Product sales consist primarily of revenue from the sale of hardware and software products that Aware ships to customers on a recurring basis, such as full-rate ADSL modems, access routers, transceiver modules, development systems, and compression software.

Contract revenue consists primarily of license, engineering development, and customer support fees that Aware is paid under development and license agreements with semiconductor and equipment manufacturers. The majority of contract revenue is due upon the completion of development milestones or the provision of customer support by Aware. Remaining contract revenue consists primarily of license fees, which are due upon transfers of pre-existing intellectual property or upon pre-determined dates. Contract revenue also includes revenue from U.S. government research contracts.

Royalties consist of royalty payments to Aware under development and license agreements. Royalties are due upon shipment of chipset or equipment products by Aware's customers. Such royalty payments are based on a fixed dollar amount for each unit of product shipped or a percentage of net revenue from the sale of customer products.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, certain line items from the Company's consolidated statements of operations as a percentage of total revenue:

Year ended December 31,	1998	1997	1996
Revenue:			
Product sales	26.2%	39.3%	31.7%
Contract revenue	70.2	60.3	68.3
Royalties	3.6	0.4	—
Total revenue	100.0	100.0	100.0
Costs and expenses:			
Cost of product sales	11.8	20.2	15.7
Cost of contract revenue	46.0	56.1	41.3
Research and development	33.0	54.7	19.7
Sales and marketing	24.0	36.9	14.5
General and administrative	18.7	31.4	18.9
Total costs and expenses	133.5	199.3	110.1
Loss from operations	(33.5)	(99.3)	(10.1)
Other income and expense	3.4	—	—
Interest income	11.0	27.5	15.0
Net income (loss)	(19.1)%	(71.8)%	4.9%

Product Sales

Product sales increased 27.0% from $2.4 million in 1997 to $3.1 million in 1998. As a percentage of total revenue, product sales decreased from 39.3% in 1997 to 26.2% in 1998. The dollar increase was primarily due to the availability of hardware products, such as ADSL development systems and the Company's x200 Access Router, for a greater portion of the year in 1998. Hardware product sales were also higher as the result of shipments of prototype transceiver modules and customer premises equipment. The dollar increase in hardware product sales was partially offset by lower revenue from the sale of compression software products. Lower compression software sales were primarily the result of a significant sale to a single customer in 1997 that did not reoccur to the same degree in 1998.

Product sales increased 44.9% from $1.7 million in 1996 to $2.4 million in 1997. As a percentage of total revenue, product sales increased from 31.7% in 1996 to 39.3% in 1997. The dollar increase was primarily due to higher revenue from the sale of: (i) transceiver module and development system hardware products, which were introduced in the second quarter of 1997, and (ii) compression software products. Increased compression software sales were primarily the result of a significant sale to a single customer in 1997 that did not occur in 1996. Higher product sales from the sale of new hardware products and compression software products were partially offset by a modest decline in revenue from the sale of modems.

Contract Revenue

Contract revenue increased 121.7% from $3.7 million in 1997 to $8.3 million in 1998. As a percentage of total revenue, contract revenue increased from 60.3% in 1997 to 70.2% in 1998. The dollar increase was primarily due to a substantial increase in contract revenue from Aware's lead telecommunications semiconductor customers, including ADI, Lucent, and Siemens. Higher contract revenue from these lead customers was attributable to new projects with ADI, up-front license payments from ADI for early ADI customer access to the Company's DSL-Lite software, and the addition of Lucent and Siemens as new customers. The dollar increase in telecommunications contract revenue was partially offset by a decline in U.S. government research contract revenue.

Contract revenue increased 3.2% from $3.6 million in 1996 to $3.7 million in 1997. As a percentage of total revenue, contract revenue decreased from 68.3% in 1996 to 60.3% in 1997. The slight dollar increase is primarily due to the effects of the initial stages of a fundamental shift in Aware's business. The shift consisted of a transition away from contracts that involved the integration of Aware-based ADSL and hybrid fiber coaxial cable chipsets into customers' equipment towards contracts that involved the integration of Aware's intellectual property and software into customers' semiconductor products. As a result of this shift, contract revenue from new semiconductor and equipment manufacturer customers was higher, and contract revenue from ADSL and hybrid fiber coaxial cable equipment customers was lower. The net effect of the shift resulted in flat year over year telecommunications contract revenue. Contract revenue was also slightly higher due to a modest increase in U.S. government contract revenue.

Royalties

Royalties increased from $25,000 in 1997 to $418,000 in 1998. As a percentage of total revenue, royalties increased from 0.4% in 1997 to 3.6% in 1998. The dollar increase was primarily due to ADSL chipset royalty payments from several of the Company's lead semiconductor customers. ADSL chipset royalty payments were driven by initial shipments of chipsets to manufacturers of central office equipment and customer premise equipment, including personal computers.

Royalties increased from no revenue in 1996 to $25,000 in 1997. As a percentage of total revenue, royalties increased from 0.0% in 1996 to 0.4% in 1997. The dollar increase was primarily due to chipset royalty payments from ADI, which began in the fourth quarter of 1997.

Cost of Product Sales

Cost of product sales consists primarily of: (i) direct material, direct labor, and overhead costs to produce the Company's products, (ii) cost of goods for purchases of finished inventory from third party suppliers, and (iii) provisions for excess and obsolete inventory. Cost of product sales increased 11.4% from $1.3 million in 1997 to $1.4 million in 1998. As a percentage of product sales, cost of product sales decreased from 51.4% in 1997 to 45.1% in 1998. The dollar increase in cost of product sales was primarily due to higher volume shipments of hardware products in 1998. The decrease in cost of product sales as a percentage of product sales was primarily due to increased sales of higher margin hardware products in 1998. This rate benefit was partially offset by a higher percentage of hardware products in the product sales mix compared to compression software products, which carry significantly lower product costs than those for hardware products.

Cost of product sales increased 50.6% from $831,000 in 1996 to $1.3 million in 1997. As a percentage of product sales, cost of product sales increased from 49.5% in 1996 to 51.4% in 1997. The dollar increase in cost of product sales was primarily due to higher volume shipments of hardware products as well as higher production overhead costs in 1997. The slight increase in cost of product sales as a percentage of product sales was due to a combination of two factors that had a mostly offsetting effect on one another. Increasing the cost of product sales percentage were higher manufacturing overhead costs. Decreasing the cost of product sales percentage was a lower percentage of hardware products in the product sales mix compared to compression software products, which carry significantly lower product costs than those for hardware products.

Cost of Contract Revenue

Cost of contract revenue consists primarily of salaries for engineers and expenses for consultants, recruiting, supplies, equipment, depreciation and facilities associated with Aware's license and development agreements and U.S. government contracts. Cost of contract revenue increased 56.2% from $3.5 million in 1997 to $5.4 million in 1998. As a percentage of contract revenue, cost of contract revenue decreased from 93.0% in 1997 to 65.6% in 1998. The dollar increase in cost of contract revenue was primarily due to new projects with ADI, and the addition of new customer projects with Lucent and Siemens in 1998. Increased spending related to these new projects and customers was partially offset by: (i) lower spending on U.S. government research projects, and (ii) no spending on the Company's hybrid fiber coaxial cable ("HFC") telephony project with DSC Communications Corporation ("DSC"), which was suspended in the third quarter of 1997. The decrease in cost of contract revenue as a percentage of contract revenue was primarily due to: (i) up-front license revenue from ADI, which had minimal cost of contract revenue associated with it, and (ii) the suspension of the DSC project, which was unprofitable in 1997.

Cost of contract revenue increased 58.7% from $2.2 million in 1996 to $3.5 million in 1997. As a percentage of contract revenue, cost of contract revenue increased from 60.5% in 1996 to 93.0% in 1997. The dollar increase in cost of contract revenue was primarily due to higher spending on projects with: (i) ADI for ADSL chipset development, and (ii) several equipment customers for whom the Company was integrating Aware-technology-based chipsets into their equipment, including the HFC telephony project for DSC. The increase in cost of contract revenue as a percentage of contract revenue was primarily due to: (i) the DSC project, which was profitable in 1996 and unprofitable in 1997, and (ii) the receipt of certain license revenue from ADI in 1996, which had minimal cost of contract revenue associated with it.

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 basic research and development. Research and development expense increased 14.4% from $3.4 million in 1997 to $3.9 million in 1998. As a percentage of total revenue, research and development expense decreased from 54.7% in 1997 to 33.0% in 1998. The dollar increase was primarily due to higher spending for engineering efforts to develop and enhance Aware's: (i) DSL-Lite and full-rate ADSL technology and software, (ii) Very high-speed Digital Subscriber Line ("VDSL") technology and chipsets, (iii) full-rate ADSL and DSL-Lite application specific integrated circuit ("ASIC") cores, and (iv) compression software technology. Higher spending on these engineering efforts was partially offset by lower spending related to the development of the Company's x200 Access Router.

Research and development expense increased 225.4% from $1.0 million in 1996 to $3.4 million in 1997. As a percentage of total revenue, research and development expense increased from 19.7% in 1996 to 54.7% in 1997. The dollar increase was primarily due to higher spending for engineering efforts to develop and enhance the Company's x200 Access Router, DSL-Lite technology, and VDSL and Symmetrical Digital Subscriber Line ("SDSL") technologies.

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 increased 23.8% from $2.3 million in 1997 to $2.8 million in 1998. As a percentage of total revenue, sales and marketing expense decreased from 36.9% in 1997 to 24.0% in 1998. The dollar increase was primarily due to nonrecurring costs incurred in 1998 to better align the sales organization to execute on the Company's intellectual property and software licensing strategy.

Sales and marketing expense increased 197.1% from $769,000 in 1996 to $2.3 million in 1997. As a percentage of total revenue, sales and marketing expense increased from 14.5% in 1996 to 36.9% in 1997. The dollar increase was primarily due to: (i) the addition of sales staff to establish channels of distribution for the Company's products and technology; (ii) the addition of marketing staff; and (iii) increased levels of advertising and promotion to create awareness for Aware's products, including participation in major industry trade shows.

General and Administrative Expense

General and administrative expense consists primarily of salaries for administrative personnel, facilities costs, expenses related to being a public company and professional services, such as legal and audit expenses. General and administrative expense increased 13.5% from $1.9 million in 1997 to $2.2 million in 1998. As a percentage of total revenue, general and administrative expense decreased from 31.4% in 1997 to 18.7% in 1998. The dollar increase was primarily due to additions to the Company's finance and information systems organizations to support organizational growth.

General and administrative expense increased 93.6% from $1.0 million in 1996 to $1.9 million in 1997. As a percentage of total revenue, general and administrative expense increased from 18.9% in 1996 to 31.4% in 1997. The dollar increase was primarily due to: (i) additions to Aware's finance, information systems and administrative organizations to support organizational growth, and (ii) investor relations and public company expenses.

Other Income and Expense

Other income consists of rental income from real estate leases. Other income and expense increased from $0 in 1997 to $405,000 in 1998. When the Company completed the purchase of its headquarters building in July 1997, the terms of the purchase agreement required Aware to sublet 24,000 square feet to the seller for a period of 18 months. That sublease was completed in January 1999 and the Company does not anticipate any further sublease income.

Interest Income

Interest income decreased 24.1% from $1.7 million in 1997 to $1.3 million in 1998. The dollar decrease resulted primarily from lower cash balances attributable to: (i) the purchase and renovation of the Company's 72,000 square foot headquarters building; (ii) the acquisition of computers, software, furniture, and other equipment primarily used in engineering activities; and (iii) the use of cash to fund operating losses.

Interest income increased 114.2% from $798,000 in 1996 to $1.7 million in 1997. The dollar increase was primarily the result of higher average cash balances due to the investment of net proceeds from Aware's initial public offering for the full year, as opposed to approximately five months in 1996.

Income Taxes

Aware has made no provision for income taxes as its historical net losses have resulted in tax loss carryforwards. At December 31, 1998, Aware had available federal net operating loss carryforwards of approximately $30.3 million, which expire in 2003 through 2013, and federal research and development credit carryforwards of approximately $1.3 million, which expire in 2003 through 2013. At December 31, 1998, Aware also had available state net operating loss carryforwards of approximately $24.1 million, which expire in 1999 through 2003, and state research and development and investment tax credit carryforwards of approximately $996,000, which expire in 2006 through 2013. Of the total net operating loss carryforwards, approximately $12.0 million are attributable to the exercise of stock options, and the tax benefit from these losses, when utilized, will be credited to additional paid-in capital.

LIQUIDITY AND CAPITAL RESOURCES

Since its inception in March 1986, Aware has financed its activities primarily through the sale of stock, including an initial public offering in August 1996 that generated net proceeds of $35.2 million. In the years ended December 31, 1996, 1997 and 1998, Aware received net proceeds of $1.1 million, $2.6 million and $3.8 million, respectively, from the exercise of employee stock options.

Aware's operating activities used net cash of $586,000, $2.7 million and $2.3 million in the years ended December 31, 1996, 1997 and 1998. Cash used in operations was primarily related to funding operating losses and working capital requirements in all three years.

In the years ended December 31, 1996, 1997, and 1998, the Company made capital expenditures of $1.1 million, $10.6 million, and $1.0 million, respectively. Capital expenditures in all three years consists of spending on computer hardware and software, laboratory equipment, and furniture used principally in engineering activities. Capital spending in 1997 includes the purchase and renovation of a 72,000 square foot commercial office building for $8.2 million, which now serves as the Company's headquarters. The Company has no material commitments for capital expenditures.

At December 31, 1998, Aware had cash, cash equivalents and short-term investments of $26.6 million. Aware believes that its cash, cash equivalents and short-term investments, will be sufficient to fund its operations for at least the next twelve months.

YEAR 2000 COMPLIANCE

Many currently installed software products and computer systems are coded to accept only two digit entries in the date code field. These date code fields will need to accept four digit entries to distinguish 21st century dates from twentieth century dates. The use of software and computer systems that are not Year 2000 compliant could result in system failures or miscalculations causing disruptions of operations, including a temporary inability to process transactions, send invoices or engage in similar normal business activities. As a result, many companies' software and computer systems may need to be upgraded or replaced in order to comply with Year 2000 requirements.

The Company has implemented a program to consider and address Year 2000 issues. A project team led by members of the Company's management is making a detailed assessment of (1) software that the Company licenses to third parties and (2) software that the Company uses internally. The assessment is nearly complete and the Company has begun implementing solutions to address Year 2000 issues that it has identified.

Most of the software that the Company licenses to third parties is aimed at transmitting or compressing data and is not date sensitive. The Company does license some software that is date sensitive, which it believes is now Year 2000 compliant. Although the Company believes the software it licenses is either Year 2000 compliant or not affected by Year 2000 issues, the Company's software is typically used in conjunction with other software and computer systems supplied by third parties. The failure of other software or computer systems to be Year 2000 compliant when used in conjunction with the Company's software could cause the entire application to perform improperly. Failure of applications that contain the Company's software to be Year 2000 compliant could result in fewer or no sales of those applications, which could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company has reviewed the software it uses internally to determine whether it is Year 2000 compliant. In those instances in which installed software is not already Year 2000 compliant, the Company is planning either to replace non-compliant software with Year 2000 compliant software or to obtain patches that will make such software Year 2000 compliant. The Company is in the process of obtaining and implementing the replacement software and patches, a process that the Company expects to complete by mid 1999. Based on the foregoing, the Company currently has no reason to believe that its internal software systems will not be Year 2000 compliant.

To date, the Company has not incurred significant incremental costs in order to comply with Year 2000 requirements and does not believe it will incur significant incremental costs in the foreseeable future. However, there can be no assurance that Year 2000 errors or defects will not be discovered in software that the Company licenses or in its own internal software systems and, if such errors or defects are discovered, there can be no assurance that the costs of making such software Year 2000 compliant will not have a material adverse effect on the Company's business, financial condition and results of operations.

Although the Company has assessed whether its internal software systems are Year 2000 compliant, it has not conducted a Year 2000 review of all of its vendors and suppliers. Failure of systems maintained by the Company's vendors and suppliers to operate properly with regard to the Year 2000 and thereafter could require the Company to incur significant unanticipated expenses to remedy any problems or replace affected vendors and suppliers that could have a material adverse effect on the Company's business, financial condition and results of operations.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Annual Report, including statements regarding the anticipated development and expansion of the Company's business, the intent, belief or current expectations of the Company, its directors or its officers, primarily with respect to the future operating performance of the Company, and other statements contained herein regarding matters that are not historical facts, are "forward-looking" statements. These forward-looking statements represent the Company's present expectations or beliefs concerning future events, however, the Company cautions that such statements are qualified by important factors. Actual future results may differ materially from such statements. Factors that could adversely affect the future performance of the Company's business include, but are not limited to: the Company's history of operating losses; unpredictable and fluctuating operating results; the Company's new and unproven business model; the Company's dependence upon a limited number of licensees; the Company's dependence on equipment companies to incorporate Aware's technology; the Company's dependence on service providers and end users to purchase products and services that incorporate Aware's technology; the Company's dependence on acceptance of DSL technology for broadband access; limited intellectual property protection; risk of third party claims of infringement; an environment of rapid technological change; the Company's reliance on fundamental technology; the importance of timely new product development; competition; the Company's dependence on hiring and retaining personnel; the volatility of the Company's stock price; Year 2000 compliance; and government regulation affecting the Company. For more information, see the Company's Form 10-K filing with the Securities and Exchange Commission.

FUTURE ADOPTION OF ACCOUNTING PRONOUNCEMENTS

In 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The provisions of SFAS No. 133 are effective for periods beginning after June 15, 1999. The Company is currently evaluating the impact of SFAS No. 133 on the consolidated financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Cash and Cash Equivalents

As of December 31, 1998, the Company is exposed to market risks which primarily include changes in U.S. interest rates.

The Company maintains a portion of its cash and cash equivalents in financial instruments with purchased maturities of three months or less. These financial instruments are subject to interest rate risk and will decline in value if interest rates increase. Due to the short duration of these financial instruments, an immediate increase in interest rates would not have a material effect upon the Company's financial position.

Short-Term Investments

The Company does not hold derivative financial instruments in its short-term investment portfolio. Short-term investments consist of instruments that meet high quality standards consistent with the Company's investment policy. The Company's policy dictates that all short-term investments mature in 18 months or less. All short-term investments in the Company's portfolio bear interest at fixed rates and mature within one year. Due to the relatively short duration of the financial instruments in the portfolio, an immediate increase in interest rates would not have a material effect upon the Company's consolidated financial position.

December 31,	1998	1997
ASSETS		
Current assets:		
Cash and cash equivalents	$ 23,512,242	$ 23,496,508
Short-term investments	3,054,717	2,607,411
Accounts receivable (less allowance for doubtful accounts of $100,000 in 1998 and $50,000 in 1997)	2,901,724	1,824,119
Inventories	120,911	215,622
Prepaid expenses	252,050	290,847
Total current assets	29,841,644	28,434,507
Property and equipment, net of accumulated depreciation and amortization of $2,860,516 in 1998 and $1,330,281 in 1997	10,320,581	10,846,025
Total assets	$ 40,162,225	$ 39,280,532
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 479,705	$ 1,075,126
Accrued expenses	127,525	185,676
Accrued compensation	324,669	326,558
Accrued professional	84,000	73,370
Deferred revenue	12,500	—
Total current liabilities	1,028,399	1,660,730
Commitments and contingent liabilities		
Stockholders' equity:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized, none outstanding	—	—
Common stock, $.01 par value; 30,000,000 shares authorized; issued and outstanding, 20,911,388 in 1998 and 19,646,024 in 1997	209,114	196,460
Additional paid-in capital	55,938,189	52,640,360
Accumulated deficit	(17,013,477)	(14,764,056)
Treasury stock	—	(452,962)
Total stockholders' equity	39,133,826	37,619,802
Total liabilities and stockholders' equity	$ 40,162,225	$ 39,280,532

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

Year Ended December 31,	1998	1997	1996
Revenue:			
Product sales	$ 3,093,294	$ 2,435,365	$ 1,680,660
Contract revenue	8,285,364	3,737,786	3,620,449
Royalties	417,672	24,900	—
Total revenue	11,796,330	6,198,051	5,301,109
Costs and expenses:			
Cost of product sales	1,393,941	1,251,677	831,241
Cost of contract revenue	5,431,136	3,477,561	2,191,117
Research and development	3,886,935	3,396,576	1,043,682
Selling and marketing	2,829,596	2,285,726	769,395
General and administrative	2,205,951	1,943,187	1,003,948
Total costs and expenses	15,747,559	12,354,727	5,839,383
Loss from operations	(3,951,229)	(6,156,676)	(538,274)
Other income and expense	404,930	—	—
Interest income	1,296,878	1,708,340	797,656
Net income (loss) before provision for income taxes	(2,249,421)	(4,448,336)	259,382
Provision for income taxes	—	—	—
Net income (loss)	($ 2,249,421)	($ 4,448,336)	$ 259,382
Net income (loss) per share – basic	($0.11)	($0.23)	$0.02
Net income (loss) per share – diluted	($0.11)	($0.23)	$0.01
Weighted average shares – basic	20,343,339	19,328,252	10,841,919
Weighted average shares – diluted	20,343,339	19,328,252	17,991,446

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

Year ended December 31,	1998	1997	1996
Cash flows from operating activities:			
Net income (loss)	($ 2,249,421)	($ 4,448,336)	$ 259,382
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,530,235	901,976	352,715
Increase (decrease) from changes in assets and liabilities:			
Accounts receivable	(1,077,605)	(169,139)	(1,154,152)
Unbilled accounts receivable	—	110,722	5,539
Inventories	94,711	231,912	(407,821)
Prepaid expenses	38,797	(267,421)	(8,955)
Accounts payable	(595,421)	737,787	225,820
Accrued expenses	(49,410)	286,821	151,492
Deferred revenue	12,500	(40,000)	(10,000)
Net cash used in operating activities	(2,295,614)	(2,655,678)	(585,980)
Cash flows from investing activities:			
Purchases of property and equipment	(1,004,791)	(10,581,073)	(1,116,238)
Net sales (purchases) of short-term investments	(447,306)	3,019,314	(5,626,725)
Net cash used in investing activities	(1,452,097)	(7,561,759)	(6,742,963)
Cash flows from financing activities:			
Proceeds from issuance of common stock, net of issuance costs	3,763,445	2,621,672	36,267,535
Net cash provided by financing activities	3,763,445	2,621,672	36,267,535
Increase (decrease) in cash and cash equivalents	15,734	(7,595,765)	28,938,592
Cash and cash equivalents, beginning of period	23,496,508	31,092,273	2,153,681
Cash and cash equivalents, end of period	$23,512,242	$23,496,508	$31,092,273

Supplemental Noncash Disclosures:			
Retirement of treasury stock	$ 452,962	—	—
Conversion of preferred stock to common stock	—	—	$ 127,998

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

	Convertible Preferred Stock			
	Series B	Series C	Series D	Series E
Balance, December 31, 1995	$ 15,875	$ 13,525	$ 69,166	$ 29,432
Issuance of common stock in initial public offering, net of issuance costs, 3,910,000 shares	—	—	—	—
Exercise of common stock options, 1,083,162 shares	—	—	—	—
Conversion of preferred stock to common stock, 12,799,800 shares	(15,875)	(13,525)	(69,166)	(29,432)
Net income	—	—	—	—
Balance, December 31, 1996	—	—	—	—
Exercise of common stock options, 686,127 shares	—	—	—	—
Net loss	—	—	—	—
Balance, December 31, 1997	—	—	—	—
Exercise of common stock options, 1,258,171 shares	—	—	—	—
Issuance of common stock under employee stock purchase plan, 7,193 shares	—	—	—	—
Retirement of treasury stock	—	—	—	—
Net loss	—	—	—	—
Balance, December 31, 1998	$ —	$ —	$ —	$ —

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

Common Stock	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total Stockholders' Equity
$ 11,670	$ 13,807,945	($10,575,102)	($452,962)	$ 2,919,549
39,100	35,123,900	—	—	35,163,000
10,832	1,093,703	—	—	1,104,535
127,998	—	—	—	—
—	—	259,382	—	259,382
189,600	50,025,548	(10,315,720)	(452,962)	39,446,466
6,860	2,614,812	—	—	2,621,672
—	—	(4,448,336)	—	(4,448,336)
196,460	52,640,360	(14,764,056)	(452,962)	37,619,802
12,582	3,688,194	—	—	3,700,776
72	62,597	—	—	62,669
—	(452,962)	—	452,962	—
—	—	(2,249,421)	—	(2,249,421)
$209,114	$ 55,938,189	($17,013,477)	$ —	$39,133,826

1. NATURE OF BUSINESS

Aware, Inc. (the "Company") designs, develops, licenses and markets Digital Subscriber Line ("DSL") technology that enables high-speed Internet access over existing telephone networks. The Company licenses its intellectual property and software to semiconductor manufacturers and equipment manufacturers who sell chips and equipment incorporating Aware's technology. Aware also markets to equipment companies to encourage them to design Aware's technology into their products, and to service providers to encourage them to deploy new broadband services based on Aware's technology. The Company's technology includes intellectual property and software products such as patents, systems designs, semiconductor cores, run-time software, and hardware designs. The Company also offers hardware products, such as DSL development tools and customer premises equipment, as well as 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.

Short-Term Investments

The Company follows Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." At December 31, 1998 and 1997, the Company had categorized all securities as "available-for-sale," since the Company may liquidate these investments currently. In calculating realized gains and losses, cost is determined using specific identification. SFAS No. 115 requires that unrealized gains and losses on available-for-sale securities be excluded from earnings and reported in a separate component of stockholders' equity. As of December 31, 1998 and 1997, unrealized gains and losses were not material.

The amortized cost of securities, which approximates fair value, consists of the following at December 31, 1998 and 1997:

	Maturity		
Type of security	Less than one year	One to five years	Total
1998			
Corporate debt securities	$1,027,935	—	$1,027,935
U.S. agency securities	2,026,782	—	2,026,782
Total	$3,054,717	—	$3,054,717
1997			
Corporate debt securities	$1,574,474	—	$1,574,474
U.S. agency securities	1,032,937	—	1,032,937
Total	$2,607,411	—	$2,607,411

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. Bad debt expense was approximately $60,000, $26,000, and $20,000 for 1998, 1997, and 1996, respectively.

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 ranging from three to thirty years.

The Company accounts for the impairment of long-lived assets in accordance with the provisions of SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of."

Revenue Recognition

Effective January 1, 1998, the Company adopted Statement of Position 97-2, Software Revenue Recognition ("SOP"). This SOP applies to all entities that earn revenue on products containing software, where software is not incidental to the product as a whole. The adoption of this statement did not have a material effect on the Company's consolidated financial position or results of operations.

Product sales consist primarily of revenue from the sale of modems, access routers, transceiver modules, development systems, and compression software. Product sales are recognized upon shipment.

Contract revenue includes revenue from development and license agreements that the Company has entered into with semiconductor and equipment manufacturers. These agreements typically provide licensees the right to use the Company's proprietary technology and to receive engineering implementation services and customer support. Accordingly, contract revenue under these agreements typically consists of license fees, engineering service fees, customer support, and in some instances, nonrefundable, prepaid royalties. The majority of contract revenue is due upon the completion of milestones or the provision of customer support by the Company. Remaining contract revenue consists primarily of license fees, which are due upon transfers of pre-existing intellectual property or upon pre-determined dates.

Contract revenue related to license fees is recognized when a definitive agreement is reached, technology transfers have been effected, and no contingent factors are present. Contract revenue related to engineering service fees is generally recognized as milestone deliverables are achieved under the terms of the respective agreements. Contract revenue related to customer support fees is generally recognized as support services are provided.

Contract revenue also consists of revenue from U.S. government research contracts. Revenue from government contracts is generally recognized as services are performed.

The Company recognizes royalties upon notification of sale by its licensees. The terms of the Company's agreements generally require licensees to give notification to the Company and to pay royalties within 45 days of the end of the quarter during which the sales take place.

Income Taxes

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires the Company to 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. SFAS No. 109 also requires the Company to establish valuation allowances to offset temporary deductible differences, net operating loss carryforwards and tax credits, which are not likely to be realized.

Capitalization of Software Costs

The Company capitalizes certain internally generated software development costs after technological feasibility of the product has been established. Capitalized software costs also include amounts paid for purchased software, which has reached technological feasibility. Such costs are amortized, on a product-by-product basis, on a straight-line basis over their useful economic lives (generally two to four years), or the ratio of current gross revenues to total gross current and future revenues, whichever is greater. There were no capitalized software costs at December 31, 1998, 1997 and 1996, because such costs incurred subsequent to the establishment of technological feasibility, but prior to commercial availability, were immaterial.

Concentration of Risk

At December 31, 1998 and 1997, the Company had bank cash balances and money market investments, in excess of federally insured deposit limits of approximately $26,467,000 and $26,004,000, respectively.

Concentration of credit risk with respect to accounts receivable is limited to $922,000, $734,000, and $585,000 with three customers at December 31, 1998 and to $524,000, $400,000 and $154,000 with three customers at December 31, 1997.

Stock-Based Compensation

The Company grants stock options for a fixed number of shares to employees 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", the Company accounts for stock option grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Accordingly, the Company recognized no compensation expense for stock option grants.

Net Income (Loss) Per Share

Basic earnings per share is computed using the weighted average number of common shares outstanding during each year. Diluted earnings per common share reflects the effect of the Company's outstanding options and convertible securities, except where such items would be anti-dilutive. Because of the net loss reported in 1998 and 1997, basic and diluted per share amounts are the same.

Use of Estimates

The preparation of the Company's financial statements in conformity with generally accepted accounting principles necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and to disclose contingent assets and liabilities at the balance sheet date. Significant estimates include 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 may differ from these 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.

Recently Adopted Accounting Pronouncements

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income", which requires businesses to disclose comprehensive income and its components in their general-purpose financial statements. Comprehensive income (loss) is equal to net income (loss) for the years ended December 31, 1998, 1997 and 1996.

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information", which requires disclosures of certain financial and descriptive information about a company's operating segments. The Company organizes itself as one segment reporting to the chief operating decision-maker. Revenue consists of product sales, contract revenue, and royalties.

Future Adoption of Accounting Pronouncements

In 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The provisions of SFAS No. 133 are effective for periods beginning after June 15, 1999. The Company is currently evaluating the impact of SFAS No. 133 on the consolidated financial statements.

Reclassifications

Certain prior period amounts have been reclassified to be consistent with the current period presentation.

3. INVENTORIES

Inventories consisted of the following at December 31:

	1998	1997
Raw materials	$ 13,091	$163,555
Work-in-process	—	—
Finished goods	107,820	52,067
Total	$120,911	$215,622

4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following at December 31:

	1998	1997
Land	$ 1,080,000	$ 1,080,000
Building and improvements	7,217,953	7,144,656
Computer equipment	2,624,729	1,996,164
Furniture and fixtures	501,610	401,979
Office equipment	205,389	142,313
Manufacturing equipment	262,610	262,610
Purchased software	1,288,806	1,148,584
Total	13,181,097	12,176,306
Less accumulated depreciation and amortization	(2,860,516)	(1,330,281)
Net	$10,320,581	$10,846,025

5. INCOME TAXES

Deferred income tax assets at December 31 are attributable to the following:

	1998	1997
Federal net operating loss carryforwards	$ 10,304,000	$ 5,641,000
Research and development and other tax credit carryforwards	2,505,000	1,526,000
State net operating loss carryforwards	1,513,000	880,000
Depreciation	90,000	41,000
Accrued expenses	171,000	88,000
Prepaid expenses	—	(94,000)
Deferred revenue	5,000	—
Total	14,588,000	8,082,000
Less valuation allowance	(14,588,000)	(8,082,000)
Net	$ —	$ —

A valuation allowance is provided against temporary deductible differences, net operating loss carryforwards and tax credits, which are not likely to be realized. During 1998 and 1997, the net valuation allowance was increased to fully reserve gross deferred tax assets.

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

	1998	1997	1996
Federal statutory rate	(34)%	(34)%	34%
State rate, net of federal benefit	(6)	(6)	6
Tax credits	(44)	(17)	(69)
Operating losses and tax credits with no current tax benefit	84	57	69
Tax benefit from the utilization of net operating loss carryforwards	—	—	(40)
Effective tax rate	— %	— %	—%

Aware has made no provision for income taxes as its historical net losses have resulted in tax loss carryforwards. At December 31, 1998, Aware had available federal net operating loss carryforwards of approximately $30.3 million, which expire in 2003 through 2013, and federal research and development credit carryforwards of approximately $1.3 million, which expire in 2003 through 2013. At December 31, 1998, Aware also had available state net operating loss carryforwards of approximately $24.1 million, which expire in 1999 through 2003, and state research and development and investment tax credit carryforwards of approximately $996,000, which expire in 2006 through 2013. Of the total net operating loss carryforwards, approximately $12.0 million are attributable to the exercise of stock options and the tax benefit from these losses, when utilized, will be credited to additional paid-in capital.

6. STOCKHOLDERS' EQUITY

Common Stock

In 1996, the Company increased the number of shares of authorized common stock from 18,650,000 to 30,000,000.

In August 1996, the Company completed an initial public offering of its common stock consisting of 3,910,000 shares at $10.00 per share. Proceeds to the Company, net of issuance costs, were approximately $35,163,000 (issuance costs were approximately $3,937,000).

In accordance with the terms of the underlying agreements, all outstanding shares of Series B, C, D, and E convertible preferred stock were automatically converted into common stock upon completion of the initial public offering.

Preferred Stock

In 1996, the Company authorized 1,000,000 shares of $1.00 par value preferred stock.

7. STOCK COMPENSATION PLANS

At December 31, 1998, the Company has three stock-based compensation plans, which are described below. The Company adopted SFAS No. 123, but, as permitted, applies APB Opinion No. 25 and related Interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and its employee stock purchase plan. The Company has no performance-based stock option plans. Had compensation cost for the Company's three stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, the Company's net income (loss) and per share amounts would have been adjusted to the pro forma amounts indicated below:

Year ended December 31,	1998	1997	1996
Net income (loss)			
As reported	($2,249,421)	($4,448,336)	$ 259,382
Pro forma	($7,432,112)	($8,531,745)	($4,403,824)
Basic earnings (loss) per share			
As reported	($0.11)	($0.23)	$0.02
Pro forma	($0.37)	($0.44)	($0.41)
Diluted earnings (loss) per share			
As reported	($0.11)	($0.23)	$0.01
Pro forma	($0.37)	($0.44)	($0.24)

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,	1998	1997	1996
Average risk-free interest rate	5.15%	6.48%	6.25%
Expected life of option grants	5 years	5 years	4 years
Expected volatility of underlying stock	89%	96%	97%
Expected dividend yield	—	—	—

Fixed Stock Option Plans

The Company has two fixed option plans. Under the 1990 Incentive and Nonstatutory Stock Option Plan, the Company may grant incentive stock options or nonqualified stock options to its employees and directors for up to 2,873,002 shares of common stock. Under the 1996 Stock Option Plan, the Company may grant incentive stock options or nonqualified stock options to its employees and directors. During 1998, the Board of Directors authorized an increase in the number of shares available for grant under the 1996 Stock Option Plan from 3,000,000 to 5,000,000 shares. Under both 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.

A summary of the status of the Company's two fixed stock option plans as of December 31, 1998, 1997, and 1996, and changes during the years ending on those dates is presented below:

	1998		1997		1996	
	Shares	Wgtd. Avg. Exer. Price	Shares	Wgtd. Avg. Exer. Price	Shares	Wgtd. Avg. Exer. Price
Outstanding at beginning of year	3,554,171	$ 7.01	3,396,408	$ 5.01	2,757,500	$ 1.21
Granted	1,477,217	10.30	913,186	12.20	1,818,250	9.10
Exercised	1,258,171	2.94	686,127	3.82	1,083,162	1.02
Forfeited or cancelled	676,174	11.58	69,296	9.10	96,180	14.54
Outstanding at end of year	3,097,043	$ 9.24	3,554,171	$ 7.01	3,396,408	$ 5.01
Options exercisable at year end	1,278,888		1,754,552		1,343,617	
Weighted-average grant date fair value of options granted during the year	$7.40		$9.28		$6.07	

The following table summarizes information about stock options outstanding at December 31, 1998:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/98	Weighted-Avg. Remaining Contractual Life	Weighted-Avg. Exercise Price	Number Exercisable At 12/31/98	Weighted-Avg. Exercise Price
$1 to 2	249,199	6.3 years	$ 1.32	246,453	$ 1.32
5 to 6	378,362	9.7	5.50	25,598	5.50
8 to 9	921,962	7.4	8.25	745,451	8.25
10 to 11	388,117	8.3	10.33	134,150	10.27
11 to 12	586,467	9.5	11.54	81,019	11.50
12 to 15	525,936	8.4	12.80	16,092	12.75
18 to 24	47,000	9.9	22.91	30,125	23.44
	3,097,043	8.3	$ 9.24	1,278,888	$ 7.69

Employee Stock Purchase Plan

In June 1996, the Company 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 with the Company. A total of 100,000 shares of common stock have been reserved for issuance. As of December 31, 1998 there were 92,807 shares available for future issuance under the ESPP Plan. The Company commenced implementation of the plan in June 1998 and issued 7,193 common shares during 1998. No shares were issued under the plan in 1997 and 1996.

8. COMMITMENTS AND CONTINGENT LIABILITIES

Lease Commitments

In 1995, the Company entered into a three-year noncancelable operating lease for its principal office and research facilities commencing June 1, 1995. In November 1996, the Company entered into a twelve-month operating lease for additional space for its research facilities commencing December 1, 1996. In November 1997, both of these leases were either terminated or allowed to lapse at no cost to the Company, and the Company moved into a new building that it had purchased.

At December 31, 1998, the Company has no material operating leases.

Rental expense was approximately $4,000, $308,000, and $143,000 in 1998, 1997 and 1996, respectively.

Litigation

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

9. TRANSACTIONS WITH RELATED PARTIES

Consulting Agreements

In prior years, the Company had paid consulting fees for scientific research and development services provided by certain stockholders. The total charges from related parties approximated $8,000 in 1996. There were no amounts due to related parties at December 31, 1998, 1997 and 1996.

10. MAJOR CUSTOMERS

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

Year ended December 31,	1998	1997	1996
Customer A	29%	12%	17%
Customer B	18%	6%	—
Customer C	14%	—	—
Customer D	8%	16%	—
Customer E	4%	13%	12%
Customer F	—	7%	22%
Customer G	—	—	10%

11. EMPLOYEE BENEFIT PLAN

In 1994, the Company 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. Company contributions to the Plan are at the discretion of the Board of Directors. Company contributions were $58,000 in 1998, and there were no Company contributions in 1997 and 1996.

12. NET INCOME (LOSS) PER SHARE

A reconciliation of weighted average shares used for the basic computation and that used for the diluted computation is as follows:

Year ended December 31,	1998	1997	1996
Weighted average shares – basic	20,343,339	19,328,252	10,841,919
Dilutive effect of:			
Convertible preferred stock	—	—	5,467,106
Options	—	—	1,682,421
Weighted average shares – diluted	20,343,339	19,328,252	17,991,446

For the years ended December 31, 1998 and 1997, potential common shares are not included in the per share calculations for diluted EPS, because the effect of their inclusion would be anti-dilutive. Anti-dilutive potential shares not included in per share calculations for 1998 and 1997 were 1,027,457 and 1,676,311, respectively. For the year ended December 31, 1996, options to purchase 1,737,750 shares of common stock at an average weighted price of $8.57 per share 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.

13. QUARTERLY RESULTS OF OPERATIONS – UNAUDITED

The following table presents unaudited quarterly operating results for each of the Company's eight quarters in the two-year period ended December 31, 1998:

	1998			
Quarters ended	March 31	June 30	Sept. 30	Dec. 31
Revenue	$2,004,016	$2,431,504	$3,346,693	$4,014,117
Income (loss) from operations	(1,893,126)	(1,715,539)	(503,411)	160,847
Net income (loss)	(1,455,437)	(1,290,978)	(77,772)	574,766
Net income (loss) per share – basic	($0.07)	($0.06)	($0.00)	$0.03
Net income (loss) per share – diluted	($0.07)	($0.06)	($0.00)	$0.03

	1997			
Quarters ended	March 31	June 30	Sept. 30	Dec. 31
Revenue	$1,801,085	$1,870,417	$ 722,500	$1,804,049
Loss from operations	(724,586)	(748,143)	(2,569,699)	(2,114,248)
Net loss	(276,302)	(275,398)	(2,145,946)	(1,750,690)
Net loss per share – basic	($0.01)	($0.01)	($0.11)	($0.09)
Net loss per share – diluted	($0.01)	($0.01)	($0.11)	($0.09)

The Board of Directors and Stockholders of
Aware, Inc.

We have audited the accompanying consolidated balance sheets of Aware, Inc. and its subsidiary (the "Company") as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

Boston, Massachusetts
January 26, 1999