

BIO KEY INTERNATIONAL INC

Form 10-Q

May 05, 2009

Table of Contents

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended March 31, 2009

TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE EXCHANGE ACT

For the Transition Period from to

Commission file number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Exact Name of registrant as specified in its charter)

DELAWARE

(State or Other Jurisdiction of
Incorporation of Organization)

41-1741861

(IRS Employer
Identification Number)

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

3349 HIGHWAY 138, BUILDING D, SUITE B, WALL, NJ 07719

(Address of Principal Executive Offices)

(732) 359-1100

(Registrant's telephone number, including area code)

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined by rule 12b-2 of the Exchange Act) Yes No

Number of shares of Common Stock, \$.0001 par value per share, outstanding as of May 4, 2009 were 70,236,327

Table of Contents

BIO-KEY INTERNATIONAL, INC.

INDEX

PART I. FINANCIAL INFORMATION

Item 1	Condensed Consolidated Financial Statements:	
	<u>Balance Sheets as of March 31, 2009 and December 31, 2008</u>	3
	<u>Statements of Operations for the three months ended March 31, 2009, and 2008</u>	4
	<u>Statements of Cash Flows for the three months ended March 31, 2009, and 2008</u>	5
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 4</u>	<u>Controls and Procedures</u>	29

PART II. OTHER INFORMATION

<u>Item 1</u>	<u>Legal Proceedings</u>	29
<u>Item 6</u>	<u>Exhibits</u>	30

<u>Signatures</u>		31
-------------------	--	----

Table of Contents

PART I FINANCIAL INFORMATION

**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS**

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

	March 31, 2009 (Unaudited)	December 31, 2008
ASSETS		
Cash and cash equivalents	\$ 1,324,667	\$ 1,712,912
Accounts receivable, net of allowance for doubtful accounts of \$82,398 at March 31, 2009 and December 31, 2008	1,307,146	721,022
Costs and earnings in excess of billings on uncompleted contracts		144,551
Inventory	12,204	13,159
Prepaid expenses	102,300	96,109
Total current assets	2,746,317	2,687,753
Equipment and leasehold improvements, net	78,815	92,238
Deposits and other assets	8,112	7,812
Restricted cash	40,500	40,500
Intangible assets less accumulated amortization	397,544	582,701
Goodwill	7,836,986	7,836,986
Total non-current assets	8,361,957	8,560,237
TOTAL ASSETS	\$ 11,108,274	\$ 11,247,990
LIABILITIES		
Accounts payable	\$ 310,623	\$ 280,994
Accrued liabilities	1,112,627	1,301,889
Note payable	1,138,964	1,516,651
Deferred rent	11,446	6,541
Deferred revenue	3,798,588	3,684,476
Total current liabilities	6,372,248	6,790,551
Warrants	40,020	12,317
Redeemable preferred stock derivatives	8,066	439
Deferred rent	20,143	11,510
Deferred revenue	5,867	8,382
Total non-current liabilities	74,096	32,648
TOTAL LIABILITIES	6,446,344	6,823,199
Commitments and contingencies		
Series B redeemable convertible preferred stock: authorized, 1,000,000 shares (liquidation preference of \$1 per share); issued and outstanding 970,612 shares of \$.0001 par value at March 31, 2009 and December 31, 2008	1,011,863	1,008,224
Series C redeemable convertible preferred stock: authorized, 600,000 shares (liquidation preference of \$10 per share); issued and outstanding 592,032 shares of \$.0001 par value at March 31, 2009 and December 31, 2008	6,598,097	6,498,516
	7,609,960	7,506,740
STOCKHOLDERS EQUITY/(DEFICIT):		
Series A convertible preferred stock: authorized, 100,000 shares (liquidation preference of \$100 per share); issued and outstanding 30,557 shares of \$.0001 par value, at March 31, 2009 and December 31, 2008	3	3
Common stock authorized, 170,000,000 shares; issued and outstanding; 69,678,881 and 67,876,880 of \$.0001 par value at March 31, 2009 and December 31, 2008, respectively	6,968	6,788
Additional paid-in capital	51,603,793	51,692,103
Accumulated deficit	(54,558,794)	(54,780,843)
TOTAL STOCKHOLDERS DEFICIT	(2,948,030)	(3,081,949)
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY/(DEFICIT)	\$ 11,108,274	\$ 11,247,990

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

Table of Contents

BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three months ended March 31,	
	2009	2008
Revenues		
Services	\$ 1,945,382	\$ 1,717,270
License fees and other	1,146,605	823,148
	3,091,987	2,540,418
Costs and other expenses		
Cost of services	305,979	347,585
Cost of license fees and other	125,762	93,896
	431,741	441,481
Gross Profit	2,660,246	2,098,937
Operating Expenses		
Selling, general and administrative	1,476,225	1,789,092
Research, development and engineering	899,773	1,247,031
	2,375,998	3,036,123
Operating income (loss)	284,248	(937,186)
Other income (expenses)		
Derivative and warrant fair value adjustments	(35,330)	30,741
Interest income		899
Interest expense	(23,494)	(10,124)
Other	(3,375)	
	(62,199)	21,516
Net Income (loss)	\$ 222,049	\$ (915,670)
Basic and Diluted Earnings(Loss) per Common Share:		
Net earnings (loss) per Common Share	\$ 0.00	\$ (0.02)
Weighted Average Shares Outstanding:		
Basic and diluted	68,477,547	61,786,732

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

Table of Contents

BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	2009	2008
CASH FLOW FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 222,049	\$ (915,670)
Adjustments to reconcile net income (loss) to cash used in operating activities:		
Derivative and warrant fair value adjustments	35,330	(30,741)
Depreciation	18,194	36,555
Amortization		
Intangible assets	185,157	184,333
Deferred rent	13,538	(134,574)
Share-based compensation	52,297	266,793
Change in assets and liabilities:		
Accounts receivable trade	(586,124)	742,898
Costs and earnings in excess of billings on uncompleted contracts	144,551	(26,282)
Inventory	955	875
Prepaid expenses and other	(6,191)	3,038
Accounts payable	29,629	2,028,371
Accrued liabilities	(189,262)	(2,178,949)
Note Payable	(377,687)	
Deferred revenue	111,597	(297,019)
Net cash used for operating activities	(345,967)	(320,372)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(4,771)	(4,392)
Deposits	(300)	
Interest on Restricted cash		(900)
Net cash used by investing activities	(5,071)	(5,292)
CASH FLOW FROM FINANCING ACTIVITIES:		
Dividends	(37,207)	
Net cash used for financing activities	(37,207)	
NET DECREASE IN CASH AND CASH EQUIVALENTS	(388,245)	(325,664)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	1,712,912	964,774
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 1,324,667	\$ 639,110

Table of Contents

**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)**

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	Three Months Ended March 31,	
	2009	2008
Cash paid for:		
Interest	\$ 22,793	\$
Noncash Investing and Financing Activities:		
Issuance of common stock in exchange for Series A, B and C preferred stock and cumulative dividends in arrears, thereon	149,566	170,644

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

Table of Contents

BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2009(Unaudited)

1. **BASIS OF PRESENTATION**

The accompanying unaudited interim consolidated financial statements include the accounts of BIO-key International, Inc. and its wholly owned subsidiary (collectively, the Company) and are stated in conformity with accounting principles generally accepted in the United States, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). The operating results for interim periods are not necessarily indicative of results that may be expected for any other interim period or for the full year. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted. Significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company s financial position and the results of its operations and cash flows for the periods presented. The balance sheet at December 31, 2008 was derived from the audited financial statements, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America. These unaudited interim consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2008 (the Form 10-K).

Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* (SFAS No. 160) which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary for the deconsolidation of a subsidiary. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim statements within those fiscal years. The Company does not currently have any noncontrolling interests.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. (SFAS No.161) which amends and expands the disclosure requirements related to derivative instruments and hedging activities. The Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. The provisions of SFAS 161 are effective for the fiscal year beginning January 1, 2009. The Company will comply with the disclosure requirements of this statement if it utilizes derivative instruments or engages in hedging activities upon its effectiveness.

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

In October 2008, the FASB issued Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157, which the Company adopted as of January 1, 2008, in cases where a market is not active. The Company will comply with the clarification to the original application.

In November 2008, the FASB ratified the EITF consensus on Issue No. 08-7, *Accounting for Defensive Intangible Assets* (EITF 08-7). The consensus addresses the accounting for an intangible asset acquired in a business combination or asset acquisition that an entity does not intend to use or intends to hold to prevent others from obtaining access (a defensive intangible asset). Under EITF 08-7, a defensive intangible asset needs to be accounted as a separate unit of accounting and would be assigned a useful life based on the

Table of Contents

period over which the asset diminishes in value. EITF 08-7 was effective for transactions occurring after December 31, 2008. The Company will consider this standard in terms of intangible assets in connection with any future acquisitions.

In February 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (SFAS No. 141(R)-a) which simplifies how entities will be required to account for contingencies arising in business combinations under SFAS 141(R) *Accounting for Business Combinations*. FASB decided to amend the guidance SFAS 141(R) to require assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value, if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would be accounted for in accordance with FASB Statement No. 5 *Accounting for Contingencies* (SFAS 5) The provisions of SFAS No. 141(R)-a are applicable to business combinations consummated after January 1, 2009 for calendar year entities. The adoption of SFAS 141(R)-a will have an impact on the Company's accounting for business combinations in connection with any future acquisitions.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP 115-2). This FSP modifies the requirements for recognizing other-than-temporarily impaired debt securities and changes the existing impairment model for such securities. The FSP also requires additional disclosures for both annual and interim periods with respect to both debt and equity securities. Under the FSP, impairment of debt securities will be considered other-than-temporary if an entity (1) intends to sell the security, (2) more likely than not will be required to sell the security before recovering its cost, or (3) does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell). The FSP further indicates that, depending on which of the above factor(s) causes the impairment to be considered other-than-temporary, (1) the entire shortfall of the security's fair value versus its amortized cost basis or (2) only the credit loss portion would be recognized in earnings while the remaining shortfall (if any) would be recorded in other comprehensive income. FSP 115-2 requires entities to initially apply the provisions of the standard to previously other-than-temporarily impaired debt securities existing as of the date of initial adoption by making a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The cumulative-effect adjustment potentially reclassifies the noncredit portion of a previously other-than-temporarily impaired debt security held as of the date of initial adoption from retained earnings to accumulated other comprehensive income. This FSP is effective April 1, 2009. The Company is currently evaluating the impact of this standard.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. This FSP essentially expands the disclosure about fair value of financial instruments that were previously required only annually to also be required for interim period reporting. In addition, the FSP requires certain additional disclosures regarding the methods and significant assumptions used to estimate the fair value of financial instruments. These additional disclosures will be required beginning with the quarter ending June 30, 2009. The Company is currently evaluating the requirements of these additional disclosures.

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have incurred significant losses to date, and at March 31, 2009, we had an accumulated deficit of approximately \$55 million. In addition, broad commercial acceptance of our technology is critical to the Company's success and ability to generate future revenues.

If the Company is unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. No assurance can be given that any form of additional financing will be available on terms

Table of Contents

acceptable to the Company, that adequate financing will be obtained by the Company in order to meet its needs, or that such financing would not be dilutive to existing shareholders.

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which contemplate continuation of the Company as a going concern, and assumes continuity of operations, realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The matters described in the preceding paragraphs raise substantial doubt about the Company's ability to continue as a going concern. Recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheets is dependent upon the Company's ability to meet its financing requirements on a continuing basis, and maintain profitability in its future operations. The accompanying condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

3. SHARE BASED COMPENSATION

The Company accounts for share based compensation in accordance with the provisions of SFAS 123R, which requires measurement of compensation cost for all stock awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The majority of our share-based compensation arrangements vest over either a three or four year vesting schedule. The Company expenses its share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant. The fair value of stock options is determined using the Black-Scholes valuation model and requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (the expected option term), the estimated volatility of our common stock price over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield. Changes in these subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized as an expense in the consolidated statements of operations. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, are likely to change our valuation assumptions used to value employee stock-based awards granted in future periods. The values derived from using the Black-Scholes model are recognized as expense over the service period, net of estimated forfeitures (the number of individuals that will ultimately not complete their vesting requirements). The estimation of stock awards that will ultimately vest requires significant judgment. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

The compensation expense recognized under SFAS 123R increased the Company's operating loss by \$52,297 and \$266,793 with no effect per share (basic and diluted) for the three months ended March 31, 2009 and 2008, respectively.

The following table presents share-based compensation expenses for continuing operations included in the Company's unaudited condensed consolidated statements of operations:

	Three Months Ended March 31,	
	2009	2008
Cost of services	\$ 2,389	\$ 10,973
Selling, general and administrative	43,001	185,185
Research, development and engineering	6,907	70,635

\$ 52,297 \$ 266,793

Table of Contents

Valuation Assumptions for Stock Options

For the three months ended March 31, 2009, and 2008, 775,000 and 0 stock options were granted, respectively. The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended March 31,	
	2009	2008
Risk free interest rate	1.83%	N/A
Expected life of options (in years)	2.5-3.5	N/A
Expected dividends	0%	N/A
Volatility of stock price	87.41%	N/A

The stock volatility for each grant is determined based on the review of the experience of the weighted average of historical daily price changes of the Company's common stock over the expected option term. The expected term was determined using the simplified method for estimating expected option life, which qualify as plain-vanilla options; and the risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

EQUITY COMPENSATION PLAN INFORMATION

1996 Stock Option Plan

During 1996, the Board of Directors and stockholders of the Company adopted the 1996 Stock Option Plan (the 1996 Plan). Under the 1996 Plan, 750,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 100% of fair market value for incentive stock options and 50% for all others. The term of stock options granted may not exceed ten years. Options issued under the 1996 Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The 1996 Plan expired in May 2005.

1999 Stock Option Plan

During 1999, the Board of Directors of the Company adopted the 1999 Stock Option Plan (the 1999 Plan). The 1999 Plan was not presented to stockholders for approval and thus incentive stock options are not available under the plan. Under the 1999 Plan, 2,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of nonstatutory stock options granted may not exceed ten years. Options issued under the 1999 Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The 1999 Plan expires in August 2009.

2004 Stock Option Plan

On October 12, 2004, the Board of Directors of the Company approved the 2004 Stock Option Plan (the 2004 Plan). The 2004 Plan has not yet been presented to stockholders for approval and thus incentive stock options are not available under this plan. Under the terms of the 2004 Plan, 4,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of stock options granted may not exceed ten years. Options issued under the 2004 Plan vest pursuant to the terms of stock option

Table of Contents

agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The 2004 Plan expires in October 2014.

Non-Plan Stock Options

Periodically, the Company has granted options outside of the 1996, 1999, and 2004 Plans to various employees and consultants. In the event of change in control, as defined, certain of the non-plan options outstanding vest immediately.

Stock Option Activity

The following table summarizes stock option activity for the three months ended March 31, 2009:

	1996 Plan	1999 Plan	Number of Options		Total	Weighted average exercise price	Weighted average remaining life (in years)	Aggregate intrinsic value
			2004 Plan	Non Plan				
Outstanding, as of December 31, 2008	80,000	335,000	2,837,941	3,755,000	7,007,941	\$ 0.78		
Granted		500,000	275,000		775,000	0.087		
Exercised								
Forfeited			(79,008)		(79,008)	0.47		
Expired			(200,000)	(150,000)	(350,000)	1.05		
Outstanding, as of March 31, 2009	80,000	835,000	2,833,933	3,605,000	7,353,933	\$ 0.69	3.75	\$
Vested or expected to vest at March 31, 2009					7,149,735	\$ 0.71	3.33	\$
Exercisable at March 31, 2009					6,571,093	\$ 0.76	3.33	\$

The options outstanding and exercisable at March 31, 2009 were in the following exercise price ranges:

Range of exercise prices	Number of shares	Options Outstanding		Options Exercisable		
		Weighted average exercise price	Weighted average remaining life (in years)	Number exercisable	Weighted average exercise price	Weighted average remaining life (in years)
\$ 0.087-0.21	1,581,272	\$ 0.11	7.95	834,602	\$ 0.10	0.10
0.22-0.40	590,999	0.34	1.14	567,330	0.34	0.34
0.41-0.68	1,696,993	0.58	2.62	1,684,492	0.58	0.58
0.69-1.11	1,968,169	0.90	3.36	1,968,169	0.90	0.90
1.12-6.42	1,516,500	1.30	2.16	1,516,500	1.30	1.30
\$ 0.087-6.42	7,353,933			6,571,093		

The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.07 as of March 31, 2009 which would have been received by the option holders had all option holders exercised their options as of that date. There are no in-the-money options exercisable as of March 31, 2009.

Table of Contents

The weighted average fair value of options, as determined under SFAS No. 123R, granted during the three months ended March 31, 2009 and 2008 was \$0.056 and \$0 per share, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2009 and 2008 was \$0. The total fair value of shares vested during the three months ended March 31, 2009 and 2008 was \$81,534 and \$405,984, respectively.

As of March 31, 2009 future compensation cost related to nonvested stock options is approximately \$58,660 and will be recognized over an estimated weighted average period of approximately 1.26 years.

4. EARNINGS (LOSS) PER SHARE COMMON STOCK (EPS)

The Company's basic EPS is calculated using net income (loss) available to common shareholders and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes the effect from potential issuance of common stock, such as stock issuable pursuant to the exercise of stock options and warrants and the assumed conversion of convertible notes and preferred stock. For the three months ended March 31, 2009 and 2008, diluted per share computations are not presented since this effect would be antidilutive.

The reconciliation of the numerator of the basic and diluted EPS calculations, due to the inclusion of preferred stock dividends and accretion was as follows for the following three month periods ended March 31:

	Three Months ended March 31,	
	2009	2008
Numerator:		
Net income (loss) from continuing operations	\$ 222,049	\$ (915,670)
Convertible preferred stock dividends and accretion	(361,618)	(471,390)
Loss available to common stockholders (basic and diluted EPS)	\$ (139,569)	\$ (1,386,563)

The following table summarizes the potential weighted average shares of common stock that were excluded from the diluted per share calculation, because the effect of including these potential shares was antidilutive.

	Three Months Ended March 31,	
	2009	2008
Preferred Stock	33,155,440	33,155,440
Potentially dilutive securities	33,155,440	33,155,440

Table of Contents

Items excluded from the diluted per share calculation because the exercise price was greater than the average market price of the common shares:

	Three Months Ended March 31,	
	2009	2008
Stock options	7,353,933	6,919,001
Warrants	6,136,899	10,566,375
Total	13,490,832	17,485,376

5. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consisted of the following:

	March 31, 2009	December 31, 2008
Equipment	\$ 560,563	\$ 555,792
Furniture and fixtures	148,517	148,517
Software	136,355	136,355
Leasehold improvements	198,889	198,889
	1,044,324	1,039,553
Less accumulated depreciation and amortization	(965,509)	(947,315)
Total	\$ 78,815	\$ 92,238

6. GOODWILL AND OTHER INTANGIBLE ASSETS

The Company's goodwill resulted from the acquisition of Public Safety Group, Inc. and certain assets and assumed liabilities of the Mobile Government Division of Aether Systems, Inc. in 2004. As of March 31, 2009, and December 31, 2008, goodwill totaled \$7,836,986.

Other intangible assets consisted of the following:

	March 31, 2009			December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

Copyrighted software	\$ 1,181,429	\$ (1,181,429)	\$	\$ 1,181,429	\$ (1,122,357)	\$ 59,072
Customer relationships	617,271	(555,543)	61,728	617,271	(524,679)	92,592
Trademarks	807,872	(765,066)	42,806	807,872	(724,673)	83,199
Developed technology	434,353	(390,918)	43,435	434,353	(369,201)	65,152
Marketing agreements	605,340	(605,340)		605,340	(575,073)	30,267
Patents and patents pending	298,059	(48,484)	249,575	298,059	(45,640)	252,419
Total	\$ 3,944,324	\$ (3,546,780)	\$ 397,544	\$ 3,944,324	\$ (3,361,623)	\$ 582,701

Aggregate amortization expense for the three months ended March 31, 2009 and 2008, was \$185,157 and \$184,333 respectively.

Table of Contents

7. RESTRICTED CASH

During 2008, the Company extended its property lease at the Marlborough, MA location. Pursuant to the agreement BIO-key was to maintain a security deposit in the form of an irrevocable letter of credit in the amount of \$40,500. However, BIO-key and the landlord for the property subsequently agreed to have BIO-key place the funds in a third party escrow account, to be returned at the conclusion of the lease term, in August 2011. The escrow is recorded as the non-current asset restricted cash as at March 31, 2009 and December 31, 2008.

8. NOTES PAYABLE, CONVERTIBLE DEBT FINANCING / WARRANTS

Notes Payable

Notes Payable consisted of the following:

	March 31, 2009	December 31, 2008
Notes payable	\$ 1,138,964	\$ 1,516,651

On July 28, 2008, the Company entered into a Settlement and Mutual Release Agreement (the Settlement Agreement) with a vendor in order to resolve all matters relating to invoices totaling approximately \$2,350,000 that the Company received in January 2008 for materials that had been delivered by the vendor, as a subcontractor on a long-term project for which the Company had served as the prime contractor. Pursuant to the Settlement Agreement, the parties agreed to a payment schedule under which the Company will be required to satisfy this outstanding balance, plus interest at seven percent (7%) per annum on the unpaid portion of the balance, in full on or before June 1, 2009. In return, the vendor agreed to forbear from exercising any of its rights and remedies against the Company with respect to these amounts so long as the Company remains in compliance with its obligations under the Settlement Agreement. As of May 4, 2009 the unpaid balance of the Note, exclusive of a \$250,000 holdback, is \$279,343. See also Note 15 to these Financial Statements for details regarding an Amendment Agreement that increased the interest rate to ten percent (10%) per annum as of April 1, 2009 and extended the date of final payment to October 1, 2009.

Convertible Debt Financing/Warrants

Long-term obligations consisted of the following:

	March 31, 2009	December 31, 2008
2004		

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

FMV of warrants	\$	7,487	\$	291
2005				
FMV of warrants		19,880		6,666
2006				
FMV of warrants		12,653		5,360
Total	\$	40,020	\$	12,317

Table of Contents*Senior Convertible Term Notes*

The account balance shown represents the fair market value of warrants issued in conjunction with debt offerings undertaken from the 2004 to 2006 fiscal years. The warrants are classified as liabilities and were valued using the Black Scholes Option Pricing model with the following assumptions:

	March 31, 2009	December 31, 2008
Dividend Yield	0%	0%
Annual volatility	135-198%	112-121%
Risk-free interest rate	0.43-0.77%	0.32-0.78%

2004 and 2005 Senior Note Derivatives and Discounts

The 2004 and 2005 Senior Notes contained features that were considered embedded derivative financial instruments, such as: Principal's conversion option, Monthly Payments Conversion Option, Interest Rate Adjustment provision, and the Default provision. These features were bifurcated and recorded on the Company's balance sheet at their fair value. See Note 10.

9. ACCRUED LIABILITIES

Accrued liabilities at consisted of the following:

	March 31, 2009	December 31, 2008
Contract costs not yet invoiced by vendors	\$ 103,586	\$ 105,788
Compensation	98,063	136,620
Compensated absences	331,679	383,454
Royalties	233,218	267,400
Interest	176,083	176,083
Other	169,998	232,544
Total	\$ 1,112,627	\$ 1,301,889

10. REDEEMABLE PREFERRED STOCK

Series B Convertible Preferred Stock

The Company issued 1,000,000 shares of redeemable Series B Convertible Preferred Stock on February 23, 2006, upon the conversion of certain convertible term notes. Each share of Series B Preferred Stock has an Original Issue Price of \$1.00 per share. The holder has the option to redeem the shares of Series B Preferred Stock at any time for a number of shares of the Company's common stock equal to the Original Issue Price plus accumulated and unpaid dividends divided by the fixed conversion price of \$0.30 per share of Common Stock. The conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series B preferred stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price less than the conversion price. Mandatory conversion of all Series B shares will be automatic if, for the 30 trading days prior to January 1, 2009, the average closing bid price for one share of common stock is at least \$1.10. The shares shall be converted at the conversion price then in effect. If the average bid price for the 30

Table of Contents

trading days prior to January 1, 2009 per common share is less than \$1.10 the Company shall mandatorily redeem all remaining outstanding Series B Preferred Stock by paying cash equal to \$1.00 per share with all accrued and unpaid dividends. The Company may, at its election, redeem any or all of the remaining outstanding Series B shares in cash at a conversion price equal to \$1.20 per share, together with all accrued and unpaid dividends upon giving 30 days notice. Holders of the Series B Preferred Stock are entitled to cumulative, prior and in preference to holders of common stock dividends equal to 15% per annum of the Original Purchase Price still outstanding, payable quarterly. In any liquidation of the Company, each share of Preferred Stock is entitled to a liquidation preference on a pari passu basis with the Series A and Series C Preferred Stock before any distribution may be made on the Company's common stock.

The mandatory redemption features were triggered in January 2009 due to the passing of the applicable mandatory redemption dates and the price of the Company's common stock, as reported by the OTC Bulletin Board, trading below the applicable thresholds contained in the terms of the Preferred Stock. Absent a waiver from the holders of the Preferred Stock, the Company would therefore be required to redeem its outstanding shares of Preferred Stock, to the extent that the Company is legally permitted to do so, by paying cash to the holders of such shares in accordance with the terms of such Preferred Stock. The Company is continuing to accrue dividends at the default rate of 17%.

As of March 31, 2009, 1,000,000 shares of Series B Preferred Stock were authorized, 970,612 of which were issued and outstanding, at a par value of \$0.0001 and a liquidation preference of \$1.00 with accumulated dividends in arrears of \$41,251, which have been accreted to the principal balance of the Series B Preferred Stock.

The Preferred Stock contains features that are considered embedded derivative financial instruments: Preferred Stock's conversion option: The Preferred Stock is convertible at the Holder's option at any time at the fixed conversion price of \$0.30 per share; Quarterly Dividends Conversion Option: Holders have the option to convert the Stock's quarterly dividend payment at a conversion price of the average 10 days closing price prior to the dividend record date. These features have been bifurcated and recorded on the Company's balance sheet as liabilities at their fair value.

As of March 31, 2009, the conversion related derivatives were valued at \$1,326 by the Company's valuation specialist.

Series C Convertible Preferred Stock

The Company issued 592,032 shares of redeemable Series C Convertible Preferred Stock on August 10, 2006, upon the exchange of certain convertible term notes. Each share of Series C Preferred Stock has an Original Issue Price of \$10.00 per share. The holder has the option to redeem the shares of Series C Preferred Stock at any time for a number of shares of the Company's common stock equal to the Original Issue Price plus accumulated and unpaid dividends divided by the fixed conversion price of \$0.30 per share of Common Stock. The conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series C Preferred Stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price less than the conversion price. Mandatory conversion of all Series C shares will be automatic if, for the 30 trading days prior to January 1, 2009, the average closing bid price for one share of common stock is at least \$1.20. The shares shall be converted at the conversion price then in effect. If the average bid price for the 30 trading days prior to January 1, 2009 per common share is less than \$1.20 the Company shall mandatorily redeem all remaining outstanding Series C Preferred Stock by paying cash equal to \$10.00 per share with all accrued and unpaid dividends. The Company may, at its election, redeem any or all of the remaining outstanding Series C shares in cash at a conversion price equal to \$12.00 per share, together with all accrued and unpaid dividends upon giving 30 days notice. Holders of the Series C Preferred Stock are entitled to cumulative, prior and in preference to holders of common stock dividends equal to 15% per annum of the Original Purchase Price still outstanding, payable quarterly. In any liquidation of the Company, each share of Preferred Stock is entitled to a liquidation preference on a pari passu basis with the

Table of Contents

Series A and Series B Preferred Stock before any distribution may be made on the Company's common stock.

The mandatory redemption features were triggered in January 2009 due to the passing of the applicable mandatory redemption dates and the price of the Company's common stock, as reported by the OTC Bulletin Board, trading below the applicable thresholds contained in the terms of the Preferred Stock. Absent a waiver from the holders of the Preferred Stock, the Company would therefore be required to redeem its outstanding shares of Preferred Stock, to the extent that the Company is legally permitted to do so, by paying cash to the holders of such shares in accordance with the terms of such Preferred Stock. The Company is continuing to accrue dividends at the default rate of 17%.

As of March 31, 2009, 600,000 Shares of Series C Preferred Stock were authorized, 592,032 of which were issued and outstanding, at a par value of \$0.0001 and a liquidation preference of \$10.00 with accumulated dividends in arrears of \$677,776, which have been accreted to the principal balance of the Series C Preferred Stock.

The Preferred Stock contains features that are considered embedded derivative financial instruments: Preferred Stock's conversion option: The Preferred Stock is convertible at the Holder's option at any time at the fixed conversion price of \$0.30 per share; Quarterly Dividends Conversion Option: Holders have the option to convert the Stock's quarterly dividend payment at a conversion price of the average 10 days closing price prior to the dividend record date. These features have been bifurcated and recorded on the Company's balance sheet as liabilities, at their fair value.

As of March 31, 2009, the conversion related derivatives were valued \$6,740 by the Company's valuation specialist.

11. STOCKHOLDERS DEFICIT

Common Stock

The Company is authorized to issue 170,000,000 shares of common stock, \$.0001 par value per share, of which 69,678,881 were outstanding as of March 31, 2009.

Holders of common stock have equal rights to receive dividends when, as and if declared by the Board of Directors, out of funds legally available therefor. Holders of common stock have one vote for each share held of record and do not have cumulative voting rights.

Holders of common stock are entitled, upon liquidation of the Company, to share ratably in the net assets available for distribution, subject to the rights, if any, of holders of any preferred stock then outstanding. Shares of common stock are not redeemable and have no preemptive or similar rights. All outstanding shares of common stock are fully paid and nonassessable.

During the three months ended March 31, 2009, preferred stockholders converted accumulated dividends of \$149,566 into 1,802,001 shares of the Company's common stock.

Series A Convertible Preferred Stock

Within the limits and restrictions provided in the Company's Certificate of Incorporation, the Board of Directors has the authority, without further action by the shareholders, to issue up to 5,000,000 shares of preferred stock, \$.0001 par value per share, in one or more series, and to fix, as to any such series, any

Table of Contents

dividend rate, redemption price, preference on liquidation or dissolution, sinking fund terms, conversion rights, voting rights, and any other preference or special rights and qualifications.

In March 2004, we designated 100,000 shares of preferred stock as Series C Convertible Preferred Stock. In connection with the Company's reincorporation in Delaware on January 1, 2005, each share of Series C Convertible Preferred Stock was automatically converted into one share of Series A Convertible Preferred Stock (the Series A Shares), of which 30,557 were issued and outstanding as at March 31, 2009.

The Series A Shares accrue a cumulative annual dividend of 7% on the \$100 face amount of such shares payable June 15 and December 15 each year in shares of common stock. In the event of a liquidation, dissolution or winding up of the Company, the Series A Shares have a liquidation preference of \$100 per share (plus all accrued and unpaid dividends thereon) prior to any payment or distribution to holders of our common stock. The Series A Shares are convertible into common stock at a conversion price of \$0.30 per share. The conversion price is subject to proportional adjustment in the event of stock splits, stock dividends or reclassifications. Subject to certain exceptions, in the event we issue additional shares of common stock at a purchase price less than the conversion price of the Series A Shares, the conversion price shall be lowered to such lesser price. In the event that the average closing bid price of our common stock is less than \$1.00 per share for thirty (30) consecutive trading days at any time after November 17, 2008, we will be required to redeem the Series A Shares by payment of \$100 per share plus all accrued and unpaid dividends due thereon.

The mandatory redemption features were triggered in January 2009 due to the passing of the applicable mandatory redemption dates and the price of the Company's common stock, as reported by the OTC Bulletin Board, trading below the applicable thresholds contained in the terms of the Preferred Stock. Absent a waiver from the holders of the Preferred Stock, the Company would therefore be required to redeem its outstanding shares of Preferred Stock, to the extent that the Company is legally permitted to do so, by paying cash to the holders of such shares in accordance with the terms of such Preferred Stock. The Company is continuing to accrue dividends at the default rate of 9%.

We are required to obtain the consent of the holders of a majority of the Series A Shares in order to, among other things, issue any shares of preferred stock that are equal to or have a preference over the Series A shares or issue any shares of preferred stock, rights, options, warrants, or any other securities convertible into common stock of the Company, other than those issued to employees of the Company in the ordinary course of their employment or to consultants or other persons providing services to the Company so long as such issuances do not exceed 500,000 shares of common stock. We are also required to obtain such consent in order to, among other things, complete a sale or other disposition of any material assets, complete an acquisition of a material amount of assets, engage in a merger, reorganization or consolidation, or incur or guaranty any indebtedness in excess of \$50,000.

As of March 31, 2009 cumulative dividends in arrears related to the Series A Preferred Stock were approximately \$530,170, which have been accreted to the principal balance of the Series A Preferred Stock.

Table of ContentsWarrants

The Company has issued warrants to certain creditors, investors, investment bankers and consultants. A summary of warrant activity is as follows:

	Total Warrants	Weighted average exercise price	Weighted average remaining life (in years)	Aggregate intrinsic value
Outstanding, as of December 31, 2008	10,566,375	\$ 0.95		
Granted				
Exercised				
Expired	(4,429,476)	1.35		
Outstanding at March 31, 2009	6,136,899	0.66	1.33	\$
Vested or expected to vest at March 31, 2009	6,136,899	0.66	1.33	
Exercisable at March 31, 2009	6,136,899	0.66	1.33	

The warrants outstanding and exercisable at March 31, 2009 were in the following exercise price ranges:

Range of exercise prices	Warrants outstanding and Exercisable	
	Number of warrants	Weighted average remaining life (in years)
\$ 0.30	2,798,014	1.86
0.75	533,333	2.36
0.97	150,000	0.29
1.00	2,655,552	0.62
	6,136,899	

12. COMPREHENSIVE INCOME/(LOSS)

The Company does not have any components of accumulated other comprehensive income/(loss) as defined by SFAS No. 130 as at March 31, 2009 and December 31, 2008.

The components of comprehensive income/(loss) for the three months ended March 31, 2009 and 2008 were as follows:

March 31,
2009

March 31,
2008

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

Net Income (loss)	\$	222,049	\$	(915,670)
Unrealized gain on securities, net of tax				391,760
Total comprehensive income/(loss)	\$	222,049	\$	(523,910)

Table of Contents

13. SEGMENT INFORMATION

The Company's consolidated operations are divided into two segments: Law and Biometric. The Company evaluates performance and allocates resources based on revenues and operating income (loss). Operating income (loss) for each segment includes selling, general and administrative expenses directly attributable to the segment in addition to those allocated as a percentage based on the segment's budgeted revenues. The segmentation of operating income (loss) as noted above and detailed below reflects how management evaluates its business. Assets for the Company are commingled and are related to all operating segments. Management does not evaluate or identify the operating assets of the segments separately.

Geographically, North American sales accounted for approximately 99% and 96% of the Company's total sales for the three months ended March 31, 2009 and 2008, respectively

Summarized financial information concerning our reportable segments is shown in the following table:

	Three Months Ended March 31,	
	2009	2008
Revenue:		
Law	\$ 2,553,792	\$ 2,187,799
Biometrics	538,195	352,619
Consolidated Revenue	\$ 3,091,987	\$ 2,540,418
Segment operating income (loss)		
Law	625,440	(698,802)
Biometrics	(341,192)	(238,384)
Total Segment Operating income (loss)	284,248	(937,186)
Reconciliation to net income (loss)		
Derivative and warrant fair value adjustments	(35,330)	30,741
Interest income		899
Interest expense	(23,494)	(10,124)
Other expense	(3,375)	
Net income (loss)	\$ 222,049	\$ (915,670)

14. INCOME TAXES

The Company has adopted the provisions of Financial Accounting Standards Board Interpretation No. 48 *Accounting for the Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN No. 48). FIN No. 48 requires that the impact of tax positions be recognized in the financial statements if they are more likely than not of being sustained based on the technical merits of the position. The Company has a valuation allowance against the full amount of its net deferred taxes. The Company currently provides a valuation allowance against deferred taxes when it is more likely than not that some portion, or all of its deferred tax assets will not be realized.

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

As a result of the implementation of FIN No. 48, the Company reduced its deferred tax assets and the associated valuation allowance for gross unrecognized tax affected benefits by approximately \$4,100,000. There was no adjustment to accumulated deficit as a result of these unrecognized tax benefits since there was a full valuation allowance against the related deferred tax assets. If these unrecognized tax benefits are

Table of Contents

ultimately recognized, they would have no impact on the effective tax rate due to the existence of the valuation allowance.

The Company has not been audited by the Internal Revenue Service (IRS) or any states in connection with income taxes. The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The periods from 2006-2008 remain open to examination by the IRS and state jurisdictions. The Company believes it is not subject to any tax risk beyond the preceding discussion. The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. The Company does not have any accrued interest or penalty associated with any unrecognized tax benefits, nor was any significant interest expense recognized during the three months ended March 31, 2009 and 2008.

15. SUBSEQUENT EVENT

On July 28, 2008, the Company entered into a Settlement and Mutual Release Agreement (the Settlement Agreement) with a vendor in order to resolve all matters relating to invoices totaling approximately \$2,350,000 that the Company received in January 2008 for materials that had been delivered by the vendor, as a subcontractor on a long-term project for which the Company had served as the prime contractor. On April 3, 2009, the Company amended the agreement (Amendment Agreement), effective as of April 1, 2009, which amended the Settlement and Mutual Release Agreement. Pursuant to the Settlement Agreement, the parties agreed to a payment schedule under which the Company was required to satisfy this outstanding balance, plus interest at seven percent (7%) per annum on the unpaid portion of the balance, in full on or before June 1, 2009. The Amendment Agreement amended this payment schedule by increasing the interest rate to ten percent (10%) per annum as of April 1, 2009 and extending the date of final payment to October 1, 2009. Additionally, the Amendment Agreement provides that an aggregate of \$250,000 of the outstanding balance will be withheld by the Company until the Company receives certain statements and/or payments related to the long-term project from the Company's customer. As of May 4, 2009 the unpaid balance of the Note, exclusive of the holdback, is \$279,343.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

The information contained in this Report on Form 10-Q and in other public statements by the Company and Company officers include or may contain certain forward-looking statements. All statements other than statements of historical facts contained in this Report on Form 10-Q, including statements regarding our future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words anticipate, believe, estimate, will, may, future, plan, intend and expect and similar expressions identify forward-looking statements. Although we believe that our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure that they will be achieved. Actual results may differ materially from the forward-looking statements contained herein due to a number of factors.

Many of these factors are set forth in the Company's Annual Report on Form 10-K under the caption Risk Factors and other filings with the Securities and Exchange Commission. These factors are not intended to represent a complete list of the general or specific factors that may affect us. It should be recognized that other factors, including general economic factors and business strategies may be significant, presently or in the future. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

OVERVIEW

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

BIO-key develops and delivers advanced identification solutions and information services to customers in both the private sector and government, including law enforcement departments, and public safety agencies. Our high-performance, yet easy-to-deploy biometric finger identification technology accurately identifies and authenticates users of wireless and enterprise data, improving security, convenience and privacy while reducing identity theft. Our mobile wireless technology provides first responders with critical, reliable, real-time data and images from local, state and national databases. Today, over 750 police departments in North America depend on BIO-key solutions, making us one of the leading supplier of mobile and wireless solutions for public safety worldwide

In 2004, BIO-key acquired Public Safety Group, Inc. (PSG), a privately held company that is a leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology is PocketCop, a handheld solution that provides mobile officers, such as detectives who are not typically in their vehicles, a hand-held mobile information software solution.

Also in 2004, BIO-key completed a transaction with Aether Systems, Inc. to purchase its Mobile Government Division (Mobile Government or AMG), a leading provider of wireless data solutions for use by public safety organizations, primarily state, local police, fire and rescue and emergency medical services organizations. Our PacketCluster mobile information software is integrated with 50 separate State/NCIC databases, as well as other state, local and federal databases. Its open architecture and its published Application Programming Interface (API) make it easy to interface with a wide range of information sources. PacketCluster products deliver real-time information in seconds, freeing dispatchers to handle more pressing emergencies.

In 2007, BIO-key completed a transaction with ZOLL Data Systems, Inc. (ZOLL), a subsidiary of ZOLL Medical Corporation, in which ZOLL acquired substantially all of the assets related to the Company's Fire/EMS Services division.

Table of Contents

As a result of these transactions, we have organized the Company into two reporting segments: Law Enforcement and Biometrics.. Law Enforcement s mobile wireless technology provides first responders with critical, reliable, real-time data and images from local, state and national databases. Biometric s high performance, scalable, cost-effective and easy-to-deploy biometric fingerprint identification technology identifies and authenticates individuals to improve security, convenience and privacy and to reduce identity theft. . The Company continues to focus on its primary objectives of increasing revenue and managing expenses, by continuing to develop and deploy leadership technology and applications, while providing its existing and new customers with high quality support and service

CRITICAL ACCOUNTING POLICIES

For detailed information on our critical accounting policies and estimates, see our financial statements and notes thereto included in this Report and in our Annual Report on Form 10-K, for the year ended December 31, 2008. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-K filed on March 11, 2009.

Table of Contents**RESULTS OF OPERATIONS****THREE MONTHS ENDED MARCH 31, 2009 AS COMPARED TO MARCH 31, 2008****INTRODUCTION**

Our business is organized into Biometric and Law Enforcement segments organized to quickly respond to market needs. Each segment is headed by a General Manager focusing on growing the business as well as driving down costs to achieve profitability.

A detailed analysis of both segments can be found below.

Consolidated Results of Operations - Percent Trend

	Three Months Ended March 31,	
	2009	2008
Revenues		
Services	63%	68%
License fees and other	37%	32%
	100%	100%
Costs and other expenses		
Cost of services	10%	14%
Cost of license fees and other	4%	4%
	14%	18%
Gross Profit	86%	82%
Operating expenses		
Selling, general and administrative	48%	70%
Research, development and engineering	29%	49%
	77%	119%
Operating Income (Loss)	9%	-37%
Other income (deductions)		
Total other income (deductions)	-2%	1%
Net Income (Loss)	7%	-36%

The Company evaluates performance and allocates resources based on revenues and operating income (loss). Operating income (loss) for each segment includes selling, general and administrative expenses directly attributable to the segment in addition to those allocated as a percentage based on the segments revenues and other factors. The segmentation of operating income as noted above and detailed below reflects how management now evaluates its business. Assets for the Company are commingled and are related to all operating segments. Management does not evaluate or identify the operating assets of the segments separately.

Table of Contents

	Three months ended March 31,		\$ Change	% Change
	2009	2008		
Revenues				
Law Enforcement				
Service	\$ 1,814,032	\$ 1,684,155	\$ 129,877	8%
License & other	739,760	503,644	236,116	47%
	2,553,792	2,187,799	365,993	17%
Biometrics				
Service	131,350	33,115	98,235	297%
License & other	406,845	319,504	87,341	27%
	538,195	352,619	185,576	53%
Total Revenue	\$ 3,091,987	\$ 2,540,418	\$ 551,569	22%
Cost of goods sold				
Law Enforcement				
Service	\$ 277,821	\$ 337,237	\$ (59,416)	-18%
License & other	6,100	54,697	(48,597)	-89%
	283,921	391,934	(108,013)	-28%
Biometrics				
Service	28,158	10,348	17,810	172%
License & other	119,662	39,199	80,463	205%
	147,820	49,547	98,273	198%
Total COGS	\$ 431,741	\$ 441,481	\$ (9,740)	-2%

RevenuesLaw Enforcement

Service revenue for the three months ended March 31, 2009 increased 8% from the same period in 2008, attributed to an increased maintenance customer base. License revenue for the three months ended March 31, 2009 increased 47% from the same period in 2008, as a result of adding more than 25 new customers.

Biometrics

For the three months ended March 31, 2009, Service revenue for the Biometrics segment increased 297% as the Company continued to add bundled maintenance agreements to its expanding customer license base, as well renewed existing maintenance agreements from its legacy customers during the period. License revenue increased 27% and was positively impacted by a large order from a new customer.

Costs of goods sold

Law Enforcement

Cost of service for the three months ended March 31, 2009 decreased 18% from the same period in 2008 due to costs associated with a specialized project included in 2008. The decrease in License & other costs for the first quarter of 2009 is due to the mix of orders containing more standalone BIO-key software and less third-party products.

Table of ContentsBiometrics

For the three months ended March 31, 2009, cost of service increased 172%, due to increased customer support for expanding customer base.

Costs of License and other for the three months ended March 31, 2009 increased 205% due to an increase costs for temporary outside services required to support specific customer order requirements.

Selling, general and administrative

	Three months ended March 31,		\$ Change	% Change
	2009	2008		
Law Enforcement	\$ 994,925	\$ 1,509,651	\$ (514,726)	-34%
Biometrics	481,300	279,441	201,859	72%
Total	\$ 1,476,225	\$ 1,789,092	\$ (312,867)	-17%

Selling, general and administrative costs for the three months ended March 31, 2009 decreased 17% from the same period in 2008. The three months ended March 31, 2008 included \$185,000 in non-cash compensation charges recognized in accordance with FAS123R. Reduction in rent expense was also significant contributor to the decrease.

Research, development and engineering

	Three months ended March 31,		\$ Change	% Change
	2009	2008		
Law Enforcement	\$ 649,506	\$ 985,016	\$ (335,510)	-34%
Biometrics	250,267	262,015	(11,748)	-4%
Total	\$ 899,773	\$ 1,247,031	\$ (347,258)	-28%

Law Enforcement & Biometrics

For the three months ended March 31, 2009, research, development and engineering costs decreased 28% from the same period in 2008 as a result of lower payroll and related benefits cost, and temporary outside services.

Table of ContentsOther income and expense

	Three months ended		\$ Change	% Change
	2009	March 31, 2008		
Derivative and warrant fair value adjustments	\$ (35,330)	\$ 30,741	\$ (66,071)	-215%
Interest income		899	(899)	-100%
Interest expense	(23,494)	(10,124)	(13,370)	132%
Other income (expense)	(3,375)		(3,375)	n/a
Total	\$ (62,199)	\$ 21,516	\$ (83,715)	-389%

For the quarter ended March 31, 2009, derivative and warrant fair value adjustments increased, when compared to the 2008 period, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt in 2004 and 2005. The fair value of the derivatives will fluctuate based on; our stock price on the valuation date, the debt conversion price, the volatility of our stock price over a period of time, changes in the value of the risk free interest rate, and the time to maturity of the outstanding debt at different points in time. Stock price is the major driver behind the movement in the Company's balances. In dollar terms, our stock price increased 40 % during the 2009 period over the prior quarter in 2008.

For the quarter ended March 31, 2009, the increase in interest expense was attributable to the repayment of the Note Payable.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operations during the three months ended March 31, 2009 was approximately \$346,000. The cash used for operating activities was primarily due to the following items:

- Positive cash flows related to a decrease in accounts receivable of approximately \$586,000, augmented by a increase in deferred revenue of approximately \$112,000,
- Negative cash flows from a decrease in note payable and accrued expenses of approximately \$567,000 due to the timing of payments.

The following non-cash items reflected in the Company's statement of operations are used to reconcile the net income to the net cash used in operating activities during the period ended March 31, 2009:

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

- The Company issued notes in 2004, 2005 and 2006 and preferred stock in 2006, all of which contained embedded derivatives, and associated warrants. In 2009, the Company realized losses of approximately \$35,000 related to the increase in value of the derivatives and associated warrants. The increase in value is driven mainly by the increase in value of the underlying BIO-key stock.
- The Company recorded approximately \$185,000 of charges in 2009 for the expense of amortizing intangible assets.
- The Company recorded approximately \$52,000 of charges in 2009 for the expense of issuing options to employees for services.

Table of Contents

Working capital deficit at March 31, 2009 was approximately \$3,585,000 as compared to a deficit of approximately \$4,103,000 at December 31, 2008. The improvement was driven mainly by the Company's net income from current operations plus non-cash expenses.

Since January 7, 1993 (date of inception), our capital needs have been principally met through proceeds from the sale of equity and debt securities.

We do not expect any material capital expenditures during the next twelve months.

We do not currently maintain a line of credit or term loan with any commercial bank or other financial institution.

Liquidity outlook

At March 31, 2009, our total of cash and cash equivalents was \$1,324,667, as compared to \$1,712,912 at December 31, 2008.

As discussed above, the Company has financed itself through access to the capital markets by issuing convertible debt securities, convertible preferred stock and common stock. We currently require approximately \$900,000 per month to conduct our operations. During the first three months of the 2009, we generated approximately \$3,092,000 of revenue. While the Company expects to increase revenue through the remainder of 2009, there can be no assurance that we will achieve that goal.

The Company's Series A Convertible Preferred Stock was redeemable in cash by the stockholders within 10 days after December 31, 2008, since certain stock price performance conditions were not met. This obligation is still outstanding and continues to accrue dividends at an increased default rate.

In addition, the Company's Series B and Series C Convertible Preferred Stock were redeemable in cash by the stockholders during the first quarter of 2009, since certain stock price performance conditions were not met. These obligations are still outstanding and continue to accrue dividends at an increased default rate.

The Company has received waivers from the holders of 64% of the outstanding preferred shares, representing 89% of the outstanding shares other than the shares held by Longview Special Finance, Inc. and Longview Fund, L.P.

If we are unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

customer base; and (ii) provide working capital. Therefore, we will need to obtain additional financing through the issuance of debt or equity securities, or to restructure our financial position through similar transactions to those consummated during 2006 and 2007.

At March 31, 2009, the Company owes a note payable for approximately \$1,138,000 from a vendor that had been a subcontractor on a long term project for which the Company was the prime contractor. The Company recently renegotiated with the vendor to extend the payment plan to satisfy this obligation, at an increased interest rate. As of May 4, 2009, the unpaid balance of the Note, exclusive of a \$250,000 holdback, is \$279,343. See also Note 15 to these Financial Statements.

Due to several factors, including our history of losses and limited revenue, our former and current independent auditors have included an explanatory paragraph in opinions they have previously issued related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. In addition, the recent financial crisis in the global capital markets and the current negative global economic trends have had an adverse impact on market participants including, among other things, volatility in security prices, diminished liquidity, and

Table of Contents

limited access to financing. These events could, therefore, effect our efforts to commercialize our technology and to obtain adequate financing. In particular, these conditions could impact the ability and willingness of our current and prospective customers to make investments in our technology and pay their obligations to us. To the extent that we require such additional financing, no assurance can be given that any form of additional financing will be available on terms acceptable to us, that adequate financing will be obtained to meet our needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or we fail to continue to generate meaningful revenue, we may be required to further reduce operating expenses, delay the expansion of operations, be unable to pursue merger or acquisition candidates, or continue as a going concern.

ITEM 4. CONTROLS AND PROCEDURES

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

Disclosure Controls and Procedures

An evaluation of the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13(a)-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of March 31, 2009 was carried out by the Company under the supervision and with the participation of the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO).

During the review of the Company's operating results for the period covered by this report, our CEO and CFO determined that, as of March 31, 2009, our disclosure controls and procedures were effective in providing reasonable assurance that information we are required to disclose in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission rules and forms. Our management reached this conclusion after identifying our system to capture disclosure items, our internal process of review for account reconciliations, our documentation of internal controls and our internal process for preparing our quarterly report on Form 10-Q for the quarterly period ended March 31, 2009 as being adequate to provide such assurance.

Changes in Internal Control Over Financial Reporting.

No change in our internal control over financial reporting occurred during the fiscal quarter ended March 31, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On February 2, 2009, Longview Special Finance, Inc. and Longview Fund, L.P. (the Plaintiffs) filed a complaint against the Company in the United States District Court for the Southern District of New York entitled Longview Special Finance, Inc. and Longview Fund, L.P. v. BIO-key International, Inc., in which the Plaintiffs are seeking \$2,915,950 in damages and an unspecified amount of interest and attorney s fees from the Company as a result of the Company s alleged improper failure to redeem, on or prior to January 10, 2009, the outstanding shares of the Company s Series B Convertible Preferred Stock and Series C Convertible Preferred Stock held by the Plaintiffs. The Company believes that it has meritorious defenses and it intends to defend against these claims vigorously.

Table of Contents

ITEM 6. EXHIBITS

The exhibits listed in the Exhibits Index immediately preceding such exhibits are filed as part of this Report.

Table of Contents

SIGNATURES

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10-Q

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BIO-Key International, Inc.

Dated: May 5, 2009

/s/ MICHAEL W. DEPASQUALE
Michael W. DePasquale
Chief Executive Officer

Dated: May 5, 2009

/s/ THOMAS J. COLATOSTI
Thomas J. Colatosti
Chief Financial Officer

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
31.1(1)	Certificate of CEO of Registrant required under Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
31.2 (1)	Certificate of CFO of Registrant required under Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
32.1(1)	Certificate of CEO of Registrant required under 18 U.S.C. Section 1350
32.2 (1)	Certificate of CFO of Registrant required under 18 U.S.C. Section 1350

(1) Filed herewith