

BIO KEY INTERNATIONAL INC  
Form 10-Q  
August 16, 2010  
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# 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 June 30, 2010

or

**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

41-1741861

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(State or Other Jurisdiction of  
Incorporation of Organization)

(IRS Employer  
Identification Number)

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

(Address of Principal Executive Offices)

**(732) 359-1100**

(Issuer's Telephone Number)

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 August 13, 2010 were 78,155,413.

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Table of Contents**PART I FINANCIAL INFORMATION****BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|---|--|------------------------------|
| <b>ASSETS</b>   |  |                              |
| Cash and cash equivalents   | \$ 504,325                               | \$ 792,426                   |
| Restricted cash   |  | 40,500                       |
| Accounts receivable, net of allowance for doubtful accounts of \$11,526 at June 30, 2010 and December 31, 2009  | 1,923,711                                | 847,215                      |
| Note receivable , current portion   | 1,334,000                                | 1,334,000                    |
| Inventory   | 12,707                                   | 14,935                       |
| Prepaid expenses and other  | 160,788                                  | 123,911                      |
| Total current assets  | 3,935,531                                | 3,152,987                    |
| Equipment and leasehold improvements, net   | 31,344                                   | 39,243                       |
| Deposits and other assets   | 8,712                                    | 8,712                        |
| Note receivable, net of current portion   | 2,666,000                                | 2,666,000                    |
| Intangible assets less accumulated amortization   | 224,300                                  | 230,259                      |
| Total non-current assets  | 2,930,356                                | 2,944,214                    |
| <b>TOTAL ASSETS</b>   | <b>\$ 6,865,887</b>                      | <b>\$ 6,097,201</b>          |
| <b>LIABILITIES</b>  |  |                              |
| Accounts payable  | \$ 453,223                               | \$ 340,241                   |
| Accrued liabilities   | 627,039                                  | 708,765                      |
| Deferred revenue  | 327,964                                  | 200,996                      |
| Convertible notes, derivatives and warrants   | 444,439                                  | 471,483                      |
| Redeemable preferred stock derivatives  | 4,158                                    | 563,599                      |
| Total current liabilities   | 1,856,823                                | 2,285,084                    |
| Warrants  |  | 63,901                       |
| Deferred revenue  | 7,769                                    | 9,391                        |
| Total non-current liabilities   | 7,769                                    | 73,292                       |
| <b>TOTAL LIABILITIES</b>  | <b>1,864,592</b>                         | <b>2,358,376</b>             |
| Series D redeemable convertible preferred stock: authorized, 100,000 shares (liquidation preference of \$100 per share); issued and outstanding 30,557 shares of \$.0001 par value at June 30, 2010 and December 31, 2009 | 2,949,827                                | 2,630,593                    |
|   | 2,949,827                                | 2,630,593                    |
| <b>STOCKHOLDERS EQUITY:</b>   |  |                              |
| Common stock authorized, 170,000,000 shares; issued and outstanding; 77,713,398 of \$.0001 par value at June 30, 2010 and December 31, 2009   | 7,771                                    | 7,771                        |
| Additional paid-in capital  | 50,895,666                               | 51,187,754                   |
| Accumulated deficit   | (48,851,969)                             | (50,087,293)                 |
| <b>TOTAL STOCKHOLDERS EQUITY</b>  | <b>2,051,468</b>                         | <b>1,108,232</b>             |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>  | <b>\$ 6,865,887</b>                      | <b>\$ 6,097,201</b>          |

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<br>June 30, |                | Six months ended<br>June 30, |                |
|---|--------------------------------|----------------|------------------------------|----------------|
|   | 2010                           | 2009           | 2010                         | 2009           |
| <b>Revenues</b>                                     |                                |                |                              |                |
| Services  | \$ 112,345                     | \$ 84,154      | \$ 204,388                   | \$ 215,504     |
| License fees and other                              | 1,320,706                      | 196,531        | 2,204,838                    | 603,375        |
|   | 1,433,051                      | 280,685        | 2,409,226                    | 818,879        |
| <b>Costs and other expenses</b>                     |                                |                |                              |                |
| Cost of services                                    | 19,760                         | 15,291         | 50,188                       | 32,709         |
| Cost of license fees and other                      | 84,081                         | 53,140         | 163,753                      | 172,802        |
|   | 103,841                        | 68,431         | 213,941                      | 205,511        |
| Gross Profit  | 1,329,210                      | 212,254        | 2,195,285                    | 613,368        |
| <b>Operating Expenses</b>                           |                                |                |                              |                |
| Selling, general and administrative                 | 897,442                        | 846,753        | 1,597,462                    | 1,725,214      |
| Research, development and engineering               | 275,135                        | 223,510        | 559,924                      | 473,777        |
|   | 1,172,577                      | 1,070,263      | 2,157,386                    | 2,198,991      |
| Operating profit (loss)                             | 156,633                        | (858,009)      | 37,899                       | (1,585,623)    |
| <b>Other income (expenses)</b>                      |                                |                |                              |                |
| Derivative and warrant fair value adjustments       | 190,577                        | (19,646)       | 977,287                      | (54,977)       |
| Interest income                                     | 60,953                         |                | 120,952                      |                |
| Interest expense                                    | (164,347)                      | (12,752)       | (327,083)                    | (36,245)       |
| Other   |                                |                |                              | (3,375)        |
|   | 87,183                         | (32,398)       | 771,156                      | (94,597)       |
| Income (loss) from continuing operations            | 243,816                        | (890,407)      | 809,055                      | (1,680,220)    |
| Income (loss) from discontinued operations          | (9,050)                        | 1,030,177      | 426,269                      | 2,042,039      |
| Net income  | 234,766                        | 139,770        | 1,235,324                    | 361,819        |
| Convertible preferred stock dividends and accretion | (160,499)                      | (365,636)      | (319,234)                    | (727,254)      |
| Income (loss) available to common stockholders      | \$ 83,317                      | \$ (1,256,043) | \$ 489,821                   | \$ (2,407,474) |
| <b>Basic Earnings per Common Share:</b>             |                                |                |                              |                |
| Income (loss) from continuing operations            | \$ 0.00                        | \$ (0.01)      | \$ 0.01                      | \$ (0.04)      |
| Income (loss) from discontinued operations          | 0.00                           | 0.01           | 0.00                         | 0.03           |
| Net income (loss)                                   | \$ 0.00                        | \$ 0.00        | \$ 0.01                      | \$ (0.01)      |
| <b>Diluted Earnings per Common Share:</b>           |                                |                |                              |                |
| Income (loss) from continuing operations            | \$ 0.00                        | \$ (0.01)      | \$ 0.00                      | \$ (0.04)      |
| <b>Weighted Average Shares Outstanding:</b>         |                                |                |                              |                |
| Basic   | 77,713,398                     | 71,291,168     | 77,713,398                   | 69,892,130     |
| Diluted   | 90,976,643                     | 71,306,168     | 91,094,752                   | 70,682,130     |

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)**

|   | <b>Six Months Ended June 30,</b> |                    |
|---|----------------------------------|--------------------|
|   | <b>2010</b>                      | <b>2009</b>        |
| <b>CASH FLOW FROM OPERATING ACTIVITIES:</b>   |                                  |                    |
| Net income  | \$ 1,235,324                     | \$ 361,819         |
| Less:   |                                  |                    |
| Income from discontinued operations   | (426,269)                        | (2,042,039)        |
| Income (loss) from continuing operations  | 809,055                          | (1,680,220)        |
| <b>Adjustments to reconcile net income (loss) to cash used in operating activities:</b> |                                  |                    |
| Derivative and warrant fair value adjustments   | (977,287)                        | 54,976             |
| Depreciation  | 12,881                           | 9,313              |
| Amortization  |                                  |                    |
| Intangible assets   | 5,959                            | 15,614             |
| Discount on convertible debt related to derivatives                                     | 326,901                          |                    |
| Share-based compensation  | 25,747                           | 59,769             |
| <b>Change in assets and liabilities:</b>  |                                  |                    |
| Accounts receivable trade   | (1,076,496)                      | (49,185)           |
| Inventory   | 2,228                            | (6,818)            |
| Prepaid expenses and other  | (36,877)                         | (24,181)           |
| Accounts payable  | 112,982                          | (11,310)           |
| Accrued liabilities   | (81,726)                         | 188,836            |
| Note payable  |                                  |                    |
| Deferred revenue  | 125,346                          | (108,419)          |
| Net cash used for continuing operations   | (751,287)                        | (1,551,625)        |
| Net provided by discontinued operations   | 427,668                          | 463,750            |
| Net cash used for operating activities  | (323,619)                        | (1,087,875)        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                  |                    |
| Capital expenditures  | (4,982)                          | (5,436)            |
| Deposits  |                                  | (899)              |
| Transfer of funds from restricted cash  | 40,500                           |                    |
| Net cash provided by (used for) continuing operations                                   | 35,518                           | (6,335)            |
| Net cash used for discontinued operations   |                                  | (17,936)           |
| Net cash provided by (used for) investing activities                                    | 35,518                           | (24,271)           |
| <b>CASH FLOW FROM FINANCING ACTIVITIES:</b>   |                                  |                    |
| Dividends   |                                  | (37,207)           |
| Net cash used for financing activities  |                                  | (37,207)           |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>  | <b>(288,101)</b>                 | <b>(1,149,353)</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                                   | <b>792,426</b>                   | <b>1,712,912</b>   |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>   | <b>\$ 504,325</b>                | <b>\$ 563,559</b>  |



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

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

|   | <b>Six Months Ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2010</b>                      | <b>2009</b> |
| Cash paid for:  |                                  |             |
| Interest  | \$                               | \$ 36,246   |
| Issuance of common stock through conversion of principal and dividends outstanding on preferred stock |                                  | 443,707     |

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

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**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

June 30, 2010 (Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited interim condensed 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 of America, 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, 2009 was derived from the audited financial statements, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed 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, 2009 (the Form 10-K), filed on March 26, 2010.

*Recently Issued Accounting Pronouncements*

In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820), Improving Disclosures about Fair Value Measurements*, amending ASC 820. ASU 2010-06 requires entities to provide new disclosures and clarify existing disclosures relating to fair value measurements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The Company is currently evaluating the impact of ASU 2010-06, but does not expect its adoption to have a material impact on the Company's financial position or results of operations.

In September 2009, the FASB issued ASU 2009-13, *Multiple Element Arrangements*. ASU 2009-13 addresses the determination of when the individual deliverables included in a multiple arrangement may be treated as separate units of accounting. ASU 2009-13 also modifies the manner in which the transaction consideration is allocated across separately identified deliverables and establishes definitions for determining fair value of elements in an arrangement. This standard must be adopted by the Company no later than January 1, 2011 with earlier adoption permitted. The Company is currently evaluating the impact, if any, that this standard update will have on its consolidated financial statements.

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have incurred significant losses to date, and at June 30, 2010, we had an accumulated deficit of approximately \$49 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

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that any form of additional financing will be available on terms 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 condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, 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 paragraph 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 as a going concern.

3. DISCONTINUED OPERATIONS

On December 8, 2009, the Company consummated the sale (the Asset Sale) of its Law Enforcement division (the Business) to InterAct911 Mobile Systems, Inc. (Buyer), a wholly-owned subsidiary of InterAct911 Corporation (the Parent), pursuant to the Asset Purchase Agreement dated as of August 13, 2009 by and between the Company and Buyer (the Purchase Agreement).

Pursuant to the Purchase Agreement, Buyer acquired substantially all of the assets relating to the Business, including the Company's customer contracts, intellectual property, accounts receivable, equipment, inventories, software, technologies, communication systems and goodwill relating to the Business. Buyer also assumed certain specified liabilities as set forth in the Purchase Agreement. The Company and InterAct Public Safety Systems, an affiliate of Buyer, had collaborated on many projects in the past, including partnership arrangements in which products used in the Business (including elements of the MobileCop®, PocketCop®, MobileRescue, MobileOffice, and InfoServer product lines) had been integrated with those of InterAct Public Safety Systems and sold to law enforcement agencies and other emergency response customers. Outside of those commercial dealings, at the time of the Asset Sale there were no material relationships among the Company and Buyer or any of their respective affiliates other than in respect of the Purchase Agreement and the related ancillary agreements.

As consideration for the Asset Sale, Buyer paid the Company an aggregate purchase price of approximately \$11.3 million. Of that amount, approximately \$7.0 million was paid in cash at the closing of the Asset Sale, and approximately \$300,000 was paid pursuant to the working capital adjustment provided for in the Purchase Agreement. Buyer also issued a promissory note (the Note) in the original principal amount of \$4.0 million in favor of the Company. The Note is to be paid in three equal annual installments beginning on December 8, 2010 and will bear interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding. The Note is guaranteed by SilkRoad Equity, LLC (SilkRoad), a private investment firm and a principal owner of Buyer, and is secured by all of the intellectual property assets of the Business transferred to Buyer as part of the Asset Sale. In addition, at the closing of the Asset Sale, the Company issued to SilkRoad a warrant to purchase up to 8 million shares of the Company's common stock at an exercise price of \$0.30 per share. This warrant will expire if not exercised prior to the fifth anniversary of the closing.

Prior to the sale, the Business had been reported as a separate segment. The Business has been reported as a discontinued operation and all periods presented have been recast accordingly to reflect these operations as discontinued.

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During the period ended June 30, 2010, the Company recorded income of approximately \$483,000 from a contract delivered under our arrangement with Buyer which was reduced by expenses for professional fees, resulting in net income from discontinued operations of approximately \$426,000. The

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Company does not expect any additional income from discontinued operations in the future. The Company and Buyer agreed to extend the period that Buyer could assert potential post closing purchase price adjustments to August 3, 2010.

## 4. SHARE BASED COMPENSATION

The Company accounts for share based compensation in accordance with the provisions of ASC 718-10, Compensation – Stock Compensation, 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 ASC 718 increased the Company's loss from continuing operations by \$14,257 and \$10,179, and \$25,747 and \$59,769 for the three and six months ended June 30, 2010 and 2009, respectively, with no effect per share (basic and diluted).

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

|                                       | <b>Three Months Ended<br/>June 30,<br/>2010</b> | <b>Three Months Ended<br/>June 30,<br/>2009</b> |
|---------------------------------------|---|---|
| Cost of services                      | \$  | \$  |
| Selling, general and administrative   | 5,462   | 8,324   |
| Research, development and engineering | 8,795   | 1,855   |
|                                       | \$ 14,257                                       | \$ 10,179                                       |
|                                       | <b>Six Months Ended<br/>June 30,<br/>2010</b>   | <b>Six Months Ended<br/>June 30,<br/>2009</b>   |
| Cost of services                      | \$  | \$  |
| Selling, general and administrative   | 10,810  | 48,902  |
| Research, development and engineering | 14,937  | 10,867  |

\$ 25,747 \$ 59,769

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For the three months ended June 30, 2010 and 2009, zero and 15,000 stock options were granted, respectively. For the six months ended June 30, 2010 and 2009, 410,000 and 790,000 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:

|                                     | <b>Three Months Ended</b> |             |
|-------------------------------------|---------------------------|-------------|
|                                     | <b>June 30,</b>           |             |
|                                     | <b>2010</b>               | <b>2009</b> |
| Risk free interest rate             | N/A                       | 1.85%       |
| Expected life of options (in years) | N/A                       | 4.5         |
| Expected dividends                  | N/A                       | 0%          |
| Volatility of stock price           | N/A                       | 87%         |

  

|                                     | <b>Six Months Ended</b> |             |
|-------------------------------------|-------------------------|-------------|
|                                     | <b>June 30,</b>         |             |
|                                     | <b>2010</b>             | <b>2009</b> |
| Risk free interest rate             | 2.36%                   | 1.83-1.85%  |
| Expected life of options (in years) | 4.25                    | 4.5         |
| Expected dividends                  | 0%                      | 0%          |
| Volatility of stock price           | 115%                    | 87%         |

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 options. The term of stock options granted could 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 in the 1996 Plan, 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 were not available under the plan. Under the 1999 Plan, 2,000,000 shares of common stock were reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which could not be below 85% of fair market value. The term of non-statutory 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 in the 1999 Plan, all options outstanding vest immediately. The 1999 Plan expired in August 2009.

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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 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 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 in the relevant agreements with recipients, certain of the non-plan options outstanding vest immediately.

*Stock Option Activity*

The following table summarizes stock option activity for the six months ended June 30, 2010:

|  | 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, 2009               | 45,000        | 500,000        | 2,073,189         | 1,329,841        | 3,948,030        | \$ 0.24                         |  |                           |
| Granted  |               |                | 410,000           |                  | 410,000          | 0.45                            |  |                           |
| Exercised  |               |                |                   |                  |                  |                                 |  |                           |
| Forfeited  |               |                |                   |                  |                  |                                 |  |                           |
| Expired  |               |                | (2,500)           |                  | (2,500)          | 0.67                            |  |                           |
| <b>Outstanding, as of June 30, 2010</b>            | <b>45,000</b> | <b>500,000</b> | <b>2,480,689</b>  | <b>1,329,841</b> | <b>4,355,530</b> | <b>0.26</b>                     | <b>4.09</b>                                | <b>\$ 58,038</b>          |
| <b>Vested or expected to vest at June 30, 2010</b> |               |                |                   |                  | <b>4,199,081</b> | <b>0.25</b>                     | <b>4.01</b>                                | <b>\$ 56,394</b>          |
| <b>Exercisable at June 30, 2010</b>                |               |                |                   |                  | <b>3,701,695</b> | <b>0.24</b>                     | <b>3.75</b>                                | <b>\$ 50,706</b>          |

The options outstanding and exercisable at June 30, 2010 were in the following exercise price ranges:

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| Range of exercise prices | Number of shares | Options Outstanding             |                                 | Weighted average remaining life (in years) | Options Exercisable |                                 |
|--------------------------|------------------|---------------------------------|---------------------------------|--|---------------------|---------------------------------|
|                          |                  | Weighted average exercise price | Weighted average exercise price |  | Number exercisable  | Weighted average exercise price |
| \$ 0.07-0.21             | 1,596,272        | \$                              | 0.11                            | 5.12                                       | 1,352,437           | \$ 0.11                         |
| 0.22-0.40                | 2,299,258        |                                 | 0.30                            | 3.07                                       | 2,229,258           | 0.30                            |
| 0.41-0.68                | 385,000          |                                 | 0.46                            | .05  | 45,000              | 0.47                            |
| 0.69-0.94                | 75,000           |                                 | 0.94                            | 1.34                                       | 75,000              | 0.94                            |
| \$ 0.07-0.94             | 4,355,530        |                                 |                                 |  | 3,701,695           |                                 |

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The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.16 as of June 30, 2010, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of June 30, 2010 was 1,224,937.

The weighted average fair value of options granted during the three months ended June 30, 2009 was \$0.05 per share, and during the six months ended June 30, 2010 and June 30, 2009 was \$0.162 and \$0.056 per share, respectively.

As of June 30, 2010 future compensation cost related to nonvested stock options is approximately \$82,985 and will be recognized over an estimated weighted average period of approximately 1.37 years.

5. 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.

The reconciliation of the numerators of the basic and diluted EPS calculations was as follows for both of the following three and six month periods ended June 30:

|  | Three Months ended June 30, |                | Six Months ended June 30, |                |
|--|-----------------------------|----------------|---------------------------|----------------|
|  | 2010                        | 2009           | 2010                      | 2009           |
| <b>Basic Numerator:</b>                                    |                             |                |                           |                |
| Income (loss) from continuing operations                   | \$ 243,816                  | \$ (890,407)   | \$ 809,055                | \$ (1,680,220) |
| Convertible preferred stock dividends and accretion        | (160,499)                   | (365,636)      | (319,234)                 | (727,254)      |
| Income (loss) available to common stockholders (basic EPS) | \$ 83,317                   | \$ (1,256,043) | \$ 489,821                | \$ (2,407,474) |
| Basic Denominator  | 77,713,398                  | 71,291,168     | 77,713,398                | 69,892,130     |
| Per Share Amount   | 0.00                        | (0.01)         | 0.01                      | (0.04)         |

The following table summarizes the potential weighted average shares of common stock for diluted per share calculation. Additional shares are excluded for the three and six month periods ended June 30, 2009, because the effect of including these potential shares was antidilutive.

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|                                 | Three Months Ended |            | Six Months Ended |            |
|---------------------------------|--------------------|------------|------------------|------------|
|                                 | June 30,           |            | June 30,         |            |
|                                 | 2010               | 2009       | 2010             | 2009       |
| Preferred Stock                 | 10,185,667         | 33,155,440 | 10,185,667       | 33,155,440 |
| Convertible Debt                | 2,459,857          |            | 2,459,857        |            |
| Stock Options                   | 617,722            | 790,000    | 735,831          | 790,000    |
| Potentially dilutive securities | 13,263,245         | 33,945,440 | 13,381,354       | 33,945,440 |

|   | Three Months ended June 30, |                | Six Months ended June 30, |                |
|---|-----------------------------|----------------|---------------------------|----------------|
|   | 2010                        | 2009           | 2010                      | 2009           |
| <b>Dilutive Numerator:</b>                                    |                             |                |                           |                |
| Income (loss) available to common stockholders (basic EPS)    | \$ 83,317                   | \$ (1,256,043) | \$ 489,821                | \$ (2,407,474) |
| Convertible preferred stock dividends and accretion           | 160,499                     |                | 319,234                   |                |
| Convertible debt interest recognized                          | 164,347                     |                | 326,935                   |                |
| Reversed derivative change in fair market value               | (170,968)                   |                | (869,852)                 |                |
| Income (loss) available to common stockholders (dilutive EPS) | \$ 237,195                  | \$ (1,256,043) | \$ 266,138                | \$ (2,407,474) |
| Dilutive Denominator:   | 90,976,643                  | 71,306,168     | 91,094,752                | 70,682,130     |
| Per Share Amount  | 0.00                        | (0.01)         | 0.00                      | (0.04)         |

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 |            | Six Months Ended |            |
|---------------|--------------------|------------|------------------|------------|
|               | June 30,           |            | June 30,         |            |
|               | 2010               | 2009       | 2010             | 2009       |
| Stock options | 2,984,258          | 6,335,441  | 2,789,258        | 6,335,441  |
| Warrants      | 15,369,948         | 6,136,899  | 15,369,948       | 6,136,899  |
| Total         | 18,354,206         | 12,472,340 | 18,159,206       | 12,472,340 |

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## 6. NOTE RECEIVABLE

Notes receivable consisted of the following:

|                               | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|-------------------------------|--|------------------------------|
| Note Receivable - Current     | \$ 1,334,000                             | \$ 1,334,000                 |
| Note Receivable - Non-Current | 2,666,000                                | 2,666,000                    |
| <b>Total</b>                  | <b>\$ 4,000,000</b>                      | <b>\$ 4,000,000</b>          |

As consideration for the Asset Sale (see Note 3 Discontinued Operations ), Buyer paid the Company an aggregate purchase price of approximately \$11.3 million. Of that amount, approximately \$7.0 million was paid in cash at the closing of the Asset Sale, and approximately \$300,000 was paid pursuant to the working capital adjustment provided for in the Purchase Agreement. Buyer also issued a promissory note (the Note ) in the original principal amount of \$4.0 million in favor of the Company. The Note is to be paid in three equal annual installments beginning on the first anniversary of the closing and will bear interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding. The Note is guaranteed by SilkRoad, a private investment firm and a principal owner of Buyer, and is secured by all of the intellectual property assets that were sold to Buyer.

## 7. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consisted of the following:

|  | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|--|--|------------------------------|
| Equipment                                      | \$ 240,930                               | \$ 235,948                   |
| Furniture and fixtures                         | 99,199                                   | 99,199                       |
| Software                                       | 28,624                                   | 28,624                       |
| Leasehold improvements                         | 39,975                                   | 39,975                       |
|  | 408,728                                  | 403,746                      |
| Less accumulated depreciation and amortization | (377,384)                                | (364,503)                    |
| <b>Total</b>                                   | <b>\$ 31,344</b>                         | <b>\$ 39,243</b>             |

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## 8. OTHER INTANGIBLE ASSETS

Other intangible assets as of June 30, 2010 consisted of the following:

|                                | June 30, 2010<br>(Unaudited) |                             |                        | December 31, 2009           |                             |                        |
|--------------------------------|------------------------------|-----------------------------|------------------------|-----------------------------|-----------------------------|------------------------|
|                                | Gross<br>Carrying<br>Amount  | Accumulated<br>Amortization | Net Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net Carrying<br>Amount |
| Patents and<br>patents pending | 287,248                      | (62,948)                    | 224,300                | 287,248                     | (56,989)                    | 230,259                |
| Total                          | \$ 287,248                   | \$ (62,948)                 | \$ 224,300             | \$ 287,248                  | \$ (56,989)                 | \$ 230,259             |

Aggregate amortization expense for the three months ended June 30, 2010 and 2009, was \$2,980 and \$2,946 respectively, and was \$5,959 and \$15,614 for the six months ended June 30, 2010 and 2009 respectively.

## 9. 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. Pursuant to the sale of the Company's Law Enforcement Business to Buyer in December 2009 (see Note 3 Discontinued Operations), the Company is no longer situated at this location, and in June 2010 assigned its obligations under the lease to Buyer.

## 10. NOTES PAYABLE, CONVERTIBLE DEBT FINANCING / WARRANTS

*Convertible Promissory Notes*

On November 12, 2009, the Company entered into a Securities Exchange Agreement (the Exchange Agreement), pursuant to which the Company and the holders of the outstanding shares of the Company's Series A Convertible Preferred Stock, agreed to exchange (a) their shares of Series A Convertible Preferred Stock for an equal number of shares of the Company's Series D Convertible Preferred Stock, and Warrants to purchase up to an aggregate of 5,000,000 shares of the Company's Common Stock, at an exercise price of \$0.30 per share, and (b) all dividends accrued and unpaid, totaling \$737,957, on their shares of Series A Convertible Preferred Stock for Seven Percent (7%) Convertible Promissory Notes (the Convertible Notes). One of the Noteholders is Thomas J. Colatosti, the Company's Chairman of the Board. At June 30, 2010, the Company owed him \$64,878.

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The Convertible Notes may be converted in whole or in part at any time at the option of the holder into shares of the Company's Common Stock at a price equal to the lower of (i) the average closing price of the Common Stock as quoted by Bloomberg for the ten (10) trading days prior to the date that the notice of conversion is transmitted to the Company, and (ii) \$0.30, subject to certain adjustments.

The Convertible Notes contain features that are considered embedded derivative financial instruments: Principal and Accrued Interest conversion option: All or a portion of the principal and all or a portion of the accrued interest of the Convertible Notes may be converted into common stock at the Holder's option at any time at lower of i) the average 10 days trading price prior to conversion, or ii) \$0.30 per share. These features have been bifurcated and recorded on the Company's balance sheet at their fair value.

The accounting treatment of the warrants and derivatives requires that the Company record the warrants and derivatives at their relative fair value and fair value, respectively as of the inception date of the agreement. As the warrants were classified as equity instruments, no further accounting adjustment is required. With respect to the derivatives, which were classified as liabilities, in subsequent periods the derivatives are marked-to-market at fair value. Any change in fair value will be recorded as non-operating, non-cash income or expense at each reporting date. If the fair value of the derivatives is higher at the subsequent balance sheet date, the Company will record a non-operating, non-cash charge. If the fair value of the derivatives is lower at the subsequent balance sheet date, the Company will record non-operating, non-cash income.

As of June 30, 2010, the derivatives were valued at \$34,480. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 0%; annual volatility of 74%; and risk free annual interest rate of 0.22% as well as probability analysis related to trading volume restrictions.

The initial fair values of the warrants and derivatives were recorded as discounts to the Convertible Notes and are being amortized to interest expense over the expected term of the debt, using the effective interest method. At June 30, 2010, the unamortized discount on the Convertible Notes was \$332,237.

Convertible note financing and warrants consisted of the following:

|                              | June 30,<br>2010<br>(Unaudited) | December 31,<br>2009 |
|------------------------------|---------------------------------|----------------------|
| <b>Current Portion</b>       |                                 |                      |
| <b>2005</b>                  |                                 |                      |
| FMV of warrants              | \$                              | \$ 47,773            |
| <b>2006</b>                  |                                 |                      |
| FMV of warrants              | 4,239                           |                      |
| <b>2009</b>                  |                                 |                      |
| Convertible promissory notes | 737,957                         | 737,957              |
| Discount                     | (332,237)                       | (659,138)            |
| FMV of embedded derivatives  | 34,480                          | 344,891              |
| <b>Total</b>                 | <b>\$ 444,439</b>               | <b>\$ 471,483</b>    |
| <b>Long-Term Portion</b>     |                                 |                      |
| <b>2006</b>                  |                                 |                      |
| FMV of warrants              |                                 | 63,901               |
| <b>Total</b>                 | <b>\$</b>                       | <b>\$ 63,901</b>     |





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*2005 and 2006 Warrants*

The account balance shown represents the fair market value of warrants issued in conjunction with debt offerings undertaken from the 2005 to 2006 fiscal years. The warrants are classified as liabilities and were valued using the Black Scholes Option Pricing model with the following assumptions:

|                         | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|-------------------------|--|------------------------------|
| Dividend Yield          | 0%                                       | 0%                           |
| Annual volatility       | 74%                                      | 107-156%                     |
| Risk-free interest rate | 0.22%                                    | 0.20-0.47%                   |

*2009 Convertible Promissory Notes*

The account balance shown represents the fair market value of convertible promissory notes issued in 2009. The notes are valued using the Binomial Option model with the following assumptions:

|                         | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|-------------------------|--|------------------------------|
| Dividend Yield          | 0%                                       | 0%                           |
| Annual volatility       | 74%                                      | 148%                         |
| Risk-free interest rate | 0.22%                                    | 0.47%                        |

11. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

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|                      | June 30,<br>2010<br>(Unaudited) | December 31,<br>2009 |
|----------------------|---------------------------------|----------------------|
| Compensation         | \$ 106,999                      | \$ 92,860            |
| Compensated absences | 154,364                         | 143,387              |
| Dividends Payable    | 128,644                         | 128,644              |
| Tax payable          | 5,000                           | 188,000              |
| Other                | 232,032                         | 155,874              |
| <b>Total</b>         | <b>\$ 627,039</b>               | <b>\$ 708,765</b>    |

## 12. REDEEMABLE PREFERRED STOCK

**Series D Convertible Preferred Stock**

The Company issued 30,557 shares of its redeemable Series D Convertible Preferred Stock to The Shaar Fund, Ltd. and Thomas Colatosti on December 28, 2009, in exchange for 30,557 shares of Series A Convertible Preferred Stock held by those shareholders. Each share of Series D Preferred Stock has an Original Issue Price of \$100.00 per share and is entitled to a dividend of 7% per annum of the liquidation preference. Each holder has the option to convert its shares of Series D Preferred Stock at any time into a number of shares of the Company's common stock equal to the Original Issue Price plus accumulated and unpaid dividends divided by the conversion price of \$0.30 per share. This conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series D Preferred Stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price per share less than the conversion price. Mandatory redemption of all of the Series D Preferred Stock shares is scheduled to occur on December 31, 2010 by the Company paying cash equal to \$100.00 per share together with all accrued and unpaid dividends. In any liquidation of the Company, each share of Series D Preferred Stock is entitled to a liquidation preference before any distribution may be made on the Company's common stock.

As of June 30, 2010, 100,000 Series D Preferred Stock shares were authorized, 30,557 of which were issued and outstanding, at a par value of \$0.0001 and a liquidation preference of \$100.00 with accumulated dividends in arrears of \$109,326, which have been accreted to the principal balance of the Series D Preferred Stock.

The Series D 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; Semi Annual Dividends Conversion Option: Holders have the option to convert the Preferred Stock's semi-annual dividend payment at any time at the fixed conversion price of \$0.30 per share. These features have been bifurcated and recorded on the Company's balance sheet as liabilities, at their fair value. As of June 30, 2010, these embedded derivatives were valued at \$4,158. An amount equal to the original value of the derivatives was recorded as a discount to the Series D Preferred Stock. The discount is being accreted to the principal balance of the Series D Preferred Stock, using the effective interest method, over the expected term of the Series D Preferred Stock. At June 30, 2010, the unamortized discount on the Series D Preferred Stock was \$215,199.

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## 13. STOCKHOLDERS EQUITY

Common Stock

The Company is authorized to issue 170,000,000 shares of common stock, \$.0001 par value per share, of which 77,713,398 shares were outstanding as of June 30, 2010.

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 therefore. 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.

Warrants

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

|   | Total Warrants | Weighted<br>average<br>exercise<br>price | Weighted<br>average<br>remaining<br>life<br>(in years) | Aggregate<br>intrinsic<br>value |
|---|----------------|--|--|---------------------------------|
| Outstanding, as of December 31, 2009        | 16,775,791     | \$ 0.33                                  | 4.09   |                                 |
| <b>Granted</b>                              |                |  |  |                                 |
| <b>Exercised</b>                            |                |  |  |                                 |
| Expired                                     | (1,405,843)    | \$ 0.52                                  |  |                                 |
| Outstanding, as of June 30, 2010            | 15,369,948     | 0.32                                     | 3.93   | \$                              |
| Vested or expected to vest at June 30, 2010 | 15,369,948     | 0.32                                     | 3.93   |                                 |
| Exercisable at June 30, 2010                | 15,369,948     | 0.32                                     | 3.93   |                                 |

The warrants outstanding and exercisable at June 30, 2010 were in the following exercise price ranges:

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| Range of exercise prices | Warrants outstanding and Exercisable |  |
|--------------------------|--------------------------------------|--|
|                          | Number of warrants                   | Weighted average remaining life (in years) |
| \$ 0.30                  | 14,836,615                           | 4.03                                       |
| 0.75                     | 533,333                              | 1.11                                       |
|                          | 15,369,948                           |  |

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14. SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of Biometric products. Prior to the sale of the Law Enforcement division in December 2009, that division had been reported as a separate segment. Geographically, North American sales accounted for approximately 96% and 97% of the Company's total sales for the three and six months ended June 30, 2010 and 2009, respectively.

15. INCOME TAXES

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.

For the six months ended June 30, 2010, \$5,000 has been accrued for state and federal tax liabilities.

16. SUBSEQUENT EVENT

The Company has evaluated subsequent events through the date of filing.

On July 27, 2010, the Company received a request from a holder of an outstanding 7% Convertible Promissory Note issued by the Company to convert \$55,694 of principal and interest due under the Note into 442,015 shares of the Company's common stock in accordance with the terms of the Note. The shares were issued on July 27, 2010.

17. FAIR VALUE OF FINANCIAL INSTRUMENTS

Cash and cash equivalents, accounts and notes receivable, accounts payable and accrued liabilities, are carried at, or approximate, fair value because of their short-term nature.

The Company's derivative financial instruments consisted of embedded derivatives related to the Convertible Notes Payable as well as the Series D Convertible Preferred Stock. These embedded derivatives include certain conversion features on debt principal and accrued interest therein, and also preferred principal and accumulated and unpaid dividends therein. The Company also issued warrants to purchase shares of the Company's Common stock as part of various debt and preferred equity financings. The accounting treatment of the warrants and derivatives requires that the Company record the warrants and derivatives at their relative fair value. The Company utilizes both the Binomial Option

Pricing Model and the Black Scholes Option Pricing Model. See Notes 10 and 12 for a further discussion.

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

**CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS**

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 most recent 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**

BIO-key International, Inc. (the Company, BIO-key, we, or us) was founded in 1993 to develop and market advanced fingerprint biometric technology and software solutions. Biometric technology is the science of analyzing specific human characteristics which are unique to each individual in order to identify a specific person from a broader population. First incorporated as BBG Engineering, the company became SAC Technologies in 1994. The BIO-key name was introduced in 2002.

We develop and market advanced fingerprint identification biometric technology and software solutions. We were among the initial pioneers in developing automated, finger identification technology that can be used without the aid of non-automated methods of identification such as a personal identification, password, token, smart card, ID card, credit card, passport, driver's license or other form of possession or knowledge based identification. This advanced BIO-key identification technology improves both the accuracy and speed of finger-based biometrics.

Since our inception in 1993, we have spent substantial time and effort in completing the development of what we believe is the most discriminating and effective commercially available finger-based biometric technology. During the past five years, our primary focus has shifted to marketing and selling this technology and completing strategic acquisitions that can help us leverage our capability to deliver identification solutions. We have built a direct sales force of professionals with substantial experience in selling technology solutions to government and corporate customers.



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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. In 2009, BIO-key completed a transaction with InterAct911 Mobile Systems, Inc. ( InterAct911 ), a subsidiary of InterAct911 Corporation, in which InterAct911 acquired substantially all the assets related to the Company's Law Enforcement division. As a result of these transactions, we have organized the Company into one reporting segment: Biometrics. The Company is now focusing on its primary objectives of increasing revenue and managing expenses, by developing leadership technology and applications, and by providing its customers with high quality support and service.

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**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, 2009. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-K filed on March 26, 2010.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820), Improving Disclosures about Fair Value Measurements*, amending ASC 820. ASU 2010-06 requires entities to provide new disclosures and clarify existing disclosures relating to fair value measurements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The Company is currently evaluating the impact of ASU 2010-06, but does not expect its adoption to have a material impact on the Company's financial position or results of operations.

In September 2009, the FASB issued ASU 2009-13, *Multiple Element Arrangements*. ASU 2009-13 addresses the determination of when the individual deliverables included in a multiple arrangement may be treated as separate units of accounting. ASU 2009-13 also modifies the manner in which the transaction consideration is allocated across separately identified deliverables and establishes definitions for determining fair value of elements in an arrangement. This standard must be adopted by the Company no later than January 1, 2011 with earlier adoption permitted. The Company is currently evaluating the impact, if any, that this standard update will have on its consolidated financial statements.

Table of Contents**RESULTS OF OPERATIONS****THREE MONTHS ENDED JUNE 30, 2010****AS COMPARED TO JUNE 30, 2009****Consolidated Results of Operations - Percent Trend**

|   | <b>Three Months Ended June 30,</b> |              |
|---|------------------------------------|--------------|
|   | <b>2010</b>                        | <b>2009</b>  |
| <b>Revenues</b>                                   |                                    |              |
| Services  | 8%                                 | 30%          |
| License fees and other                            | 92%                                | 70%          |
|   | 100%                               | 100%         |
| <b>Costs and other expenses</b>                   |                                    |              |
| Cost of services                                  | 1%                                 | 5%           |
| Cost of license fees and other                    | 6%                                 | 19%          |
|   | 7%                                 | 24%          |
| Gross Profit                                      | 93%                                | 76%          |
| <b>Operating expenses</b>                         |                                    |              |
| Selling, general and administrative               | 63%                                | 301%         |
| Research, development and engineering             | 19%                                | 80%          |
|   | 82%                                | 381%         |
| <b>Operating profit (loss)</b>                    | <b>11%</b>                         | <b>-305%</b> |
| <b>Other deductions</b>                           |                                    |              |
| Total other deductions                            | 6%                                 | -12%         |
| <b>Income (loss) from continuing operations</b>   | <b>17%</b>                         | <b>-317%</b> |
| <b>Income (loss) from discontinued operations</b> | <b>-1%</b>                         | <b>367%</b>  |
| <b>Net Income</b>                                 | <b>16%</b>                         | <b>50%</b>   |

|                           | <b>Three months ended</b> |                   |                     |                 |  |
|---------------------------|---------------------------|-------------------|---------------------|-----------------|--|
|                           | <b>June 30,</b>           |                   |                     |                 |  |
|                           | <b>2010</b>               | <b>2009</b>       | <b>\$ Change</b>    | <b>% Change</b> |  |
| <b>Revenues</b>           |                           |                   |                     |                 |  |
| Service                   | \$ 112,345                | \$ 84,154         | \$ 28,191           | 33%             |  |
| License & other           | 1,320,706                 | 196,531           | 1,124,175           | 572%            |  |
| <b>Total Revenue</b>      | <b>\$ 1,433,051</b>       | <b>\$ 280,685</b> | <b>\$ 1,152,366</b> | <b>411%</b>     |  |
| <b>Cost of goods sold</b> |                           |                   |                     |                 |  |
| Service                   | \$ 19,760                 | \$ 15,291         | \$ 4,469            | 29%             |  |
| License & other           | 84,081                    | 53,140            | 30,941              | 58%             |  |
| <b>Total COGS</b>         | <b>\$ 103,841</b>         | <b>\$ 68,431</b>  | <b>\$ 35,410</b>    | <b>52%</b>      |  |

**Revenues**

For the three months ended June 30, 2010, service revenue increased 33% from the same period in 2009 as the Company added new maintenance customers. License and other revenue for the three months ended June 30, 2010 increased by 572% attributable to several large orders from new customers and additional orders from current customers.

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*Costs of goods sold*

For the three months ended June 30, 2010, cost of services increased approximately 29% from the same period in 2009 due to increased customer support for the expanding customer base.

License and other costs increased 58% for the three months ended June 30, 2010 from the same period in 2009 by approximately \$31,000 due to an increase hardware orders and associated costs.

*Selling, general and administrative*

|  | Three months ended<br>June 30, |            |           |          |
|--|--------------------------------|------------|-----------|----------|
|  | 2010                           | 2009       | \$ Change | % Change |
| <b>Selling, general and administrative</b> | \$ 897,442                     | \$ 846,753 | \$ 50,689 | 6%       |

Selling, general and administrative expenses increase by 6% for the three months ended June 30, 2010 from the same period in 2009 for commission expenses and referral fees related to increased revenue.

*Research, development and engineering*

|  | Three months ended<br>June 30, |            |           |          |
|--|--------------------------------|------------|-----------|----------|
|  | 2010                           | 2009       | \$ Change | % Change |
| <b>Research, development and engineering</b> | \$ 275,135                     | \$ 223,510 | \$ 51,625 | 23%      |

For the three months ended June 30, 2010, research, development and engineering costs increased 23% from the same period in 2009 as the Company employed temporary outside services for specific new projects.

*Other income and expense*

Three months ended  
June 30,

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|  | 2010       | 2009        | \$ Change  | % Change |
|--|------------|-------------|------------|----------|
| <b>Derivative and warrant fair value adjustments</b> | \$ 190,577 | \$ (19,646) | \$ 210,223 | 1070%    |
| <b>Interest income</b>                               | 60,953     |             | 60,953     | 100%     |
| <b>Interest expense</b>                              | (164,347)  | (12,752)    | (151,595)  | 1189%    |
| <b>Total</b>   | \$ 87,183  | (32,398)    | \$ 119,581 | 369%     |

For the quarter ended June, 2010, the change in derivative and warrant fair value adjustments increased, when compared to same quarter 2009, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt in 2005, 2006 and 2009. 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

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of the outstanding debt at different points in time. Stock price and volatility are the major drivers behind the movement in the Company's balances.

For the quarter ended June 30, 2010, the interest income was attributable to the Note Receivable.

For the quarter ended June 30, 2009, the interest expense was attributable to the repayment of the Note Payable. For the quarter ended June 30, 2010, the interest expense was attributable to the non-cash amortization of the discount.

**SIX MONTHS ENDED JUNE 30, 2010 AS COMPARED TO JUNE 30, 2009**

**Consolidated Results of Operations - Percent Trend**

|   | Six Months Ended June 30, |       |
|---|---------------------------|-------|
|   | 2010                      | 2009  |
| <b>Revenues</b>                                   |                           |       |
| Services  | 8%                        | 26%   |
| License fees and other                            | 92%                       | 74%   |
|   | 100%                      | 100%  |
| <b>Costs and other expenses</b>                   |                           |       |
| Cost of services                                  | 2%                        | 4%    |
| Cost of license fees and other                    | 7%                        | 21%   |
|   | 9%                        | 25%   |
| Gross Profit                                      | 91%                       | 75%   |
| <b>Operating expenses</b>                         |                           |       |
| Selling, general and administrative               | 66%                       | 211%  |
| Research, development and engineering             | 23%                       | 58%   |
|   | 89%                       | 269%  |
| <b>Operating profit (loss)</b>                    | 2%                        | -194% |
| <b>Other deductions</b>                           |                           |       |
| Total other deductions                            | 32%                       | -11%  |
| <b>Income (loss) from continuing operations</b>   | 34%                       | -205% |
| <b>Income (loss) from discontinued operations</b> | 17%                       | 249%  |
| <b>Net Income (Loss)</b>                          | 51%                       | 44%   |

|                      | Six months ended<br>June 30, |    |         |              |          |
|----------------------|------------------------------|----|---------|--------------|----------|
|                      | 2010                         |    | 2009    | \$ Change    | % Change |
| <b>Revenues</b>      |                              |    |         |              |          |
| Service              | 204,388                      |    | 215,504 | (11,116)     | -5%      |
| License & other      | 2,204,838                    |    | 603,375 | 1,601,463    | 265%     |
| <b>Total Revenue</b> | \$ 2,409,226                 | \$ | 818,879 | \$ 1,590,347 | 194%     |

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*Cost of goods sold*

|                   |            |            |          |     |
|-------------------|------------|------------|----------|-----|
| Service           | 50,188     | 32,709     | 17,479   | 53% |
| License & other   | 163,753    | 172,802    | (9,049)  | -5% |
| <i>Total COGS</i> | \$ 213,941 | \$ 205,511 | \$ 8,430 | 4%  |



Table of Contents**Revenues**

Service revenue for the six months ended June 30, 2009 decreased 5% as the Company performed fewer customized software service, offset by an increased maintenance customer base compared to the prior year's corresponding period. License and other revenue for the six months ended June 30, 2010 increased by 265% due to several large orders from new customers and additional orders from current customers.

**Costs of goods sold**

For the six months ended June 30, 2010, cost of services increased approximately \$17,000 from the same period in 2009 due to increased customer support for the expanding customer base. License and other costs decreased slightly for the six months ended June 30, 2010 from the same period in 2009 by approximately \$9,000 due to the specific customer requirements for third party software.

**Selling, general and administrative**

|  | Six months ended<br>June 30, |              |              |          |
|--|------------------------------|--------------|--------------|----------|
|  | 2010                         | 2009         | \$ Change    | % Change |
| <b>Selling, general and administrative</b> | \$ 1,597,462                 | \$ 1,725,214 | \$ (127,752) | -7%      |

Selling, general and administrative costs for the six months ended June 30, 2010 decreased 7% from the same period in 2009. The six months ended June 30, 2009 included \$34,000 more than the same period in 2010 in non-cash compensation charges in accordance with the provisions of ASC 718-10. Reduction in legal and professional services expenses were also significant contributors to the decrease, offset by increased commission and referral fee expenses.

**Research, development and engineering**

|  | Six months ended<br>June 30, |            |           |          |
|--|------------------------------|------------|-----------|----------|
|  | 2010                         | 2009       | \$ Change | % Change |
| <b>Research, development and engineering</b> | \$ 559,924                   | \$ 473,777 | \$ 86,147 | 18%      |

For the six months ended June 30, 2010, research, development and engineering costs increased 18% from the six months ended June 30, 2009 related to temporary outside services expenses for specific new projects.



Table of Contents*Other income and expense*

|  | Six months ended<br>June 30, |             |              |          |  |
|--|------------------------------|-------------|--------------|----------|--|
|  | 2010                         | 2009        | \$ Change    | % Change |  |
| <b>Derivative and warrant fair value adjustments</b> | \$ 977,287                   | \$ (54,977) | \$ 1,032,264 | 1,878%   |  |
| <b>Interest income</b>                               | 120,952                      |             | 120,952      | 100%     |  |
| <b>Interest expense</b>                              | (327,083)                    | (36,245)    | (290,838)    | 802%     |  |
| <b>Other expense</b>                                 |                              | (3,375)     | 3,375        | -100%    |  |
| <b>Total</b>   | \$ 771,156                   | \$ (94,597) | \$ 865,753   | 915%     |  |

For the six months ended June, 2010, the change in derivative and warrant fair value adjustments increased, when compared to same period 2009, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt in 2005, 2006 and 2009. 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 and volatility are the major drivers behind the movement in the Company's balances.

For the six months ended June 30, 2010, the interest income was attributable to the Note Receivable.

For the six months ended June 30, 2009, the interest expense was attributable to the repayment of the Note Payable. For the six months ended June 30, 2010, the interest expense was attributable to the non-cash amortization of the discount.

**LIQUIDITY AND CAPITAL RESOURCES**

For the six months ended June 30, 2010, net cash used in continuing operations was approximately \$751,000. The cash used for continuing operations was primarily due to the following items:

- Negative cash flow due to an increase in accounts receivable of approximately \$1,076,000, offset by an increase in deferred revenue of approximately \$125,000; and
- Positive cash flows from an increase in accounts payable offset by a decrease accrued liabilities for a total of approximately \$31,000.

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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 six months ended June 30, 2010:

- The Company issued convertible notes in 2005 and 2006 and preferred stock in 2009, all of which contained embedded derivatives, and associated warrants. During the six months ended June 30, 2010, the Company realized gains of approximately \$977,000 related to the decrease in value of the derivatives and associated warrants. The decrease in value is driven mainly by the decrease in value of the underlying BIO-key stock.
- The Company recorded the amount equal to the original value of the derivatives as a discount to

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the preferred stock which is being accreted to the principal balance. The Company recorded approximately \$327,000 for discount charges during the six months ended June 30, 2010.

- The Company recorded approximately \$26,000 of charges during the six months ended June 30, 2010 for the expense of issuing options to employees for services.

Working capital at June 30, 2010 was approximately \$2,079,000, as compared to approximately \$868,000 at December 31, 2009, the improvement of which was driven mainly by the increase in accounts receivable and the decrease in redeemable preferred stock derivative as a result of the decrease in our stock price.

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 June 30, 2010, our total of cash and cash equivalents was \$504,325, as compared to \$792,426 at December 31, 2009.

As discussed above, the Company has financed itself in the past through access to the capital markets by issuing convertible debt securities, convertible preferred stock and common stock. We currently require approximately \$360,000 per month to conduct our operations. During the first six months of the 2010, we generated approximately \$2,409,000 of revenue. While the Company expects to increase revenue through the remainder of 2010, there can be no assurance that we will achieve that goal.

The Company's outstanding shares of Series D Convertible Preferred Stock are redeemable in cash by the holders of such shares on December 31, 2010. This obligation also continues to accrue dividends.

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 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, potentially through similar transactions to those consummated during 2006, 2007 and 2009.

Due to several factors, including our history of losses and limited revenue, our 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 ongoing 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 limited access to financing. These events could, therefore, affect 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

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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**

*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 June 30, 2010 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 June 30, 2010, 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 June 30, 2010 as being adequate to provide such assurance.

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*Changes in Internal Control Over Financial Reporting*

No change in our internal control over financial reporting occurred during the fiscal quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 6. EXHIBITS**

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



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**SIGNATURES**

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: August 16, 2010

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

Dated: August 16, 2010

/s/ Cecilia Welch  
Cecilia Welch  
Chief Financial Officer

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 31.1(1)            | Certificate of CEO of Registrant required under Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended |
| 31.2 (1)           | Certificate of CFO of Registrant required under Rule 13a-15(f) 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   |

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(1) Filed herewith