

BIO KEY INTERNATIONAL INC

Form 10-Q

August 12, 2008

[Table of Contents](#)

## **U.S. SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549



# FORM 10-Q



x

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

**For the quarterly period ended June 30, 2008**



o

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

**For the Transition Period from            to**









**BIO-KEY INTERNATIONAL, INC.**

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(Exact Name of Small Business Issuer as Specified in Its Charter)

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**DELAWARE**  
(State or Other Jurisdiction of  
Incorporation of Organization)

**41-1741861**  
(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)



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Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 is a shell company (as defined by rule 12b-2 of the Exchange Act)

Yes  No

Number of shares of Common Stock outstanding as of August 4, 2008 were 64,144,844, par value \$.0001 per share.

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

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Table of Contents

**BIO-KEY INTERNATIONAL, INC.**

**INDEX**

PART I. FINANCIAL INFORMATION

|               |   |   |    |
|---------------|---|---|----|
| <u>Item 1</u> | - | <u>Condensed Consolidated Financial Statements</u>  | 3  |
|               |   | <u>Balance sheets as of June 30, 2008 (unaudited) and December 31, 2007</u>                           | 4  |
|               |   | <u>Statements of operations for the three and six months ended June 30, 2008 and 2007 (unaudited)</u> | 5  |
|               |   | <u>Statements of cash flows for the six months ended June 30, 2008 and 2007 (unaudited)</u>           | 6  |
|               |   | <u>Notes to condensed consolidated financial statements</u>   | 8  |
| <u>Item 2</u> | . | <u>Management's Discussion and Analysis of Financial Conditions and Results of Operations</u>         | 24 |
| <u>Item 3</u> | . | <u>Controls and Procedures</u>  | 35 |

PART II. OTHER INFORMATION

|               |   |                 |    |
|---------------|---|-----------------|----|
| <u>Item 6</u> | . | <u>Exhibits</u> | 36 |
|---------------|---|-----------------|----|

Table of Contents

**PART I**

**FINANCIAL INFORMATION**





**ITEM 1. FINANCIAL STATEMENTS**



Table of Contents

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

**CONDENSED CONSOLIDATED BALANCE SHEETS**

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|  | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|--|---------------------------------|----------------------|
| <b>ASSETS</b>  |                                 |                      |
| Cash and cash equivalents  | \$ 624,237                      | \$ 964,774           |
| Restricted cash  |                                 | 153,094              |
| Accounts receivable, net of allowance for doubtful accounts of \$112,400 at June 30, 2008 and \$113,771 December 31, 2007  | 1,450,980                       | 2,129,797            |
| Costs and earnings in excess of billings on uncompleted contracts  | 65,705                          | 233,805              |
| Inventory  | 38,318                          | 4,879                |
| Investments  | 276,013                         |                      |
| Prepaid expenses   | 79,340                          | 119,068              |
| Total current assets   | 2,534,593                       | 3,605,417            |
| Equipment and leasehold improvements, net  | 113,376                         | 177,282              |
| Deposits and other assets  | 487,815                         | 487,815              |
| Intangible assets less accumulated amortization  | 955,557                         | 1,324,269            |
| Goodwill   | 7,836,986                       | 7,836,986            |
| Total non-current assets   | 9,393,734                       | 9,826,352            |
| <b>TOTAL ASSETS</b>  | <b>\$ 11,928,327</b>            | <b>\$ 13,431,769</b> |
| <b>LIABILITIES</b>   |                                 |                      |
| Accounts payable   | \$ 3,159,348                    | \$ 1,162,690         |
| Accrued liabilities  | 1,276,343                       | 3,401,749            |
| Deferred rent  | 94,761                          | 367,986              |
| Deferred revenue   | 3,505,493                       | 4,468,748            |
| Total current liabilities  | 8,035,945                       | 9,401,173            |
| Warrants   | 105,052                         | 64,520               |
| Redeemable preferred stock derivatives   | 11,937                          | 41,295               |
| Deferred revenue   | 24,331                          | 34,518               |
| Total non-current liabilities  | 141,320                         | 140,333              |
| <b>TOTAL LIABILITIES</b>   | <b>8,177,265</b>                | <b>9,541,506</b>     |
| <b>Commitments and contingencies</b>   |                                 |                      |
| Series B redeemable convertible preferred stock: authorized, 1,000,000 shares (liquidation preference of \$1 per share); issued and outstanding 970,612 shares of \$.0001 par value at June 30, 2008 and December 31, 2007 | 944,580                         | 881,340              |
| Series C redeemable convertible preferred stock: authorized, 600,000 shares (liquidation preference of \$10 per share); issued and outstanding 592,032 shares of \$.0001 par value at June 30, 2008 and December 31, 2007  | 6,207,160                       | 5,776,231            |
|  | 7,151,740                       | 6,657,571            |
| <b>STOCKHOLDERS DEFICIT:</b>   |                                 |                      |
| Series A convertible preferred stock: authorized, 100,000 shares (liquidation preference of \$100 per share); issued and outstanding 30,557 shares of \$.0001 par value, at June 30, 2008 and December 31, 2007            | 3                               | 3                    |
| Common stock authorized, 170,000,000 shares; issued and outstanding; 63,913,383 and 61,153,202 of \$.0001 par value at June 30, 2008 and December 31, 2007, respectively   | 6,391                           | 6,115                |
| Additional paid-in capital   | 51,964,349                      | 52,126,595           |
| Accumulated other comprehensive income   | 276,013                         |                      |
| Accumulated deficit  | (55,647,434)                    | (54,900,021)         |
| <b>TOTAL STOCKHOLDERS DEFICIT</b>  | <b>(3,400,678)</b>              | <b>(2,767,308)</b>   |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>  | <b>\$ 11,928,327</b>            | <b>\$ 13,431,769</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, |              |
|--|--------------------------------|--------------|------------------------------|--------------|
|  | 2008                           | 2007         | 2008                         | 2007         |
| <b>Revenues</b>  |                                |              |                              |              |
| Services   | \$ 1,828,345                   | \$ 1,697,467 | \$ 3,545,615                 | \$ 3,572,643 |
| License fees and other   | 1,751,608                      | 765,392      | 2,574,756                    | 1,605,456    |
|  | 3,579,953                      | 2,462,859    | 6,120,371                    | 5,178,099    |
| <b>Costs and other expenses</b>  |                                |              |                              |              |
| Cost of services   | 288,748                        | 399,580      | 636,333                      | 847,469      |
| Cost of license fees and other   | 132,430                        | 63,692       | 226,326                      | 94,603       |
|  | 421,178                        | 463,272      | 862,659                      | 942,072      |
| Gross Profit   | 3,158,775                      | 1,999,587    | 5,257,712                    | 4,236,027    |
| <b>Operating Expenses</b>  |                                |              |                              |              |
| Selling, general and administrative  | 1,695,306                      | 2,212,481    | 3,484,398                    | 4,763,776    |
| Research, development and engineering  | 1,164,217                      | 1,319,982    | 2,411,248                    | 2,676,940    |
|  | 2,859,523                      | 3,532,463    | 5,895,646                    | 7,440,716    |
| Operating Profit (loss)  | 299,252                        | (1,532,876)  | (637,934)                    | (3,204,689)  |
| <b>Other income (deductions)</b>   |                                |              |                              |              |
| Derivative and warrant fair value adjustments                                  | (41,915)                       | (158,916)    | (11,174)                     | 670,452      |
| Interest income  | 399                            | 1,331        | 1,298                        | 1,331        |
| Interest expense   | (7,884)                        | (260,801)    | (18,007)                     | (799,317)    |
| Loss on extinguishment of debt   |                                | (403,940)    |                              | (403,940)    |
| Other  | (16,142)                       | (18,000)     | (16,142)                     | (23,902)     |
|  | (65,542)                       | (840,326)    | (44,025)                     | (555,376)    |
| Income (loss) from continuing operations                                       | 233,710                        | (2,373,202)  | (681,959)                    | (3,760,065)  |
| Income (loss) from discontinued operations                                     | (65,454)                       | (34,385)     | (65,454)                     | 440,105      |
| Gain on disposal of discontinued operations, net of<br>expected<br>tax of \$0. |                                | 4,070,859    |                              | 4,070,859    |
| Net Income (loss)  | \$ 168,256                     | \$ 1,663,272 | \$ (747,413)                 | \$ 750,899   |
| <b>Basic and Diluted Earnings per Common Share:</b>                            |                                |              |                              |              |
| Income (loss) from continuing operations                                       | \$ 0.00                        | \$ (0.05)    | \$ (0.03)                    | \$ (0.08)    |
| Income (loss) from discontinued operations                                     | 0.00                           | 0.00         | 0.00                         | 0.01         |
| Gain on disposal of discontinued operations                                    | 0.00                           | 0.07         | 0.00                         | 0.07         |
| Net income (loss)  | \$ 0.00                        | \$ 0.02      | \$ (0.03)                    | \$ 0.00      |
| <b>Weighted Average Shares Outstanding:</b>                                    |                                |              |                              |              |
| Basic  | 63,180,281                     | 58,067,198   | 62,483,507                   | 57,354,818   |
| Diluted  | 63,180,281                     | 58,067,198   | 62,483,507                   | 57,354,818   |

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>2008</b>                      | <b>2007</b> |
| <b>CASH FLOW FROM OPERATING ACTIVITIES:</b>  |                                  |             |
| Net Income (loss)  | \$ (747,413)                     | \$ 750,899  |
| Less:  |                                  |             |
| (Income) loss from discontinued operations   | 65,454                           | (440,105)   |
| Gain on disposal of discontinued operations  |                                  | (4,070,859) |
| Loss from continuing operations  | (681,959)                        | (3,760,065) |
| <b>Adjustments to reconcile net loss to cash used in operating activities:</b>       |                                  |             |
| Derivative and warrant fair value adjustments  | 11,174                           | (670,452)   |
| Loss on extinguishment of debt   |                                  | 403,003     |
| Depreciation   | 68,745                           | 129,851     |
| Amortization   |                                  |             |
| Intangible assets  | 368,712                          | 368,033     |
| Deferred financing costs   |                                  | 83,871      |
| Discounts on convertible debt related to warrants and beneficial conversion features |                                  | 360,245     |
| Allowance for doubtful receivables   | (1,371)                          | (9,127)     |
| Deferred rent  | (273,225)                        | (242,473)   |
| Fair market value adjustment on equity issuance and warrant modification             |                                  | 124,999     |
| Share-based compensation   | 332,201                          | 388,984     |
| <b>Change in assets and liabilities:</b>   |                                  |             |
| Accounts receivable trade  | 680,188                          | 1,424,602   |
| Costs and earnings in excess of billings on uncompleted contracts                    | 168,100                          | 2,591       |
| Inventory  | (33,439)                         | (3,271)     |
| Prepaid expenses and other   | 39,728                           | 35,367      |
| Accounts payable   | 1,996,658                        | (172,840)   |
| Billings in excess of costs and earnings on uncompleted contracts                    |                                  | (2,680)     |
| Accrued liabilities  | (2,125,406)                      | (354,171)   |
| Deferred revenue   | (973,442)                        | (908,026)   |
| Net cash used for continuing operations  | (423,336)                        | (2,801,559) |
| Net cash provided by (used for) discontinued operations                              | (15,454)                         | 574,768     |
| Net cash used for operating activities   | (438,790)                        | (2,226,791) |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                  |             |
| Capital expenditures   | (15,371)                         | (44,575)    |
| Deposits   |                                  | 312,539     |
| Proceeds from the sale of the Fire business  |                                  | 7,000,000   |
| Transfer of funds from (to) restricted cash  | 153,094                          | (401,331)   |
| Proceeds from sale of Assets   | 10,530                           |             |
| Patent costs   |                                  | (19,109)    |
| Net cash provided by continuing operations   | 148,253                          | 6,847,524   |
| Net cash used for discontinued operations  | (50,000)                         | (7,615)     |
| Net cash provided by investing activities  | 98,253                           | 6,839,909   |
| <b>CASH FLOW FROM FINANCING ACTIVITIES:</b>  |                                  |             |
| Repayment of long term obligations   |                                  | (4,661,958) |
| Net cash used for continuing operations  |                                  | (4,661,958) |
| Net cash used for discontinued operations  |                                  |             |
| Net cash used for financing activities   |                                  | (4,661,958) |

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|   |    |           |    |          |
|---|----|-----------|----|----------|
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>      |    | (340,537) |    | (48,840) |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b> |    | 964,774   |    | 627,167  |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>       | \$ | 624,237   | \$ | 578,327  |

Table of Contents

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

|  | <b>Six Months Ended June 30,</b> |             |
|--|----------------------------------|-------------|
|  | <b>2008</b>                      | <b>2007</b> |
| <b>Cash paid for:</b>  |                                  |             |
| Interest   |                                  | 370,090     |
| <b>Noncash Investing and Financing Activities:</b>   |                                  |             |
| Conversion of convertible notes and related obligations, net of discount, and accrued interest into common stock |                                  | 772,764     |
| Issuance of common stock through conversion of principal and dividends outstanding on preferred stock            | 342,349                          | 777,870     |

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

Table of Contents

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

June 30, 2008 (Unaudited)

1. **BASIS OF PRESENTATION**

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

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company's financial position and the results of its operations and cash flows for the periods presented. The balance sheet at December 31, 2007 was derived from the audited financial statements, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. It is suggested that these unaudited interim consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2007 (the Form 10-KSB).

*Recently Issued Accounting Pronouncements*

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which is effective for calendar year companies on January 1, 2008. This Statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. The adoption of SFAS 157 had no impact on the Company's financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, (SFAS 159), which is effective for calendar year companies on January 1, 2008. This Statement allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 further establishes certain additional disclosure requirements. The adoption of SFAS 159 had no impact on the Company's financial condition and results of operations.

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In December 2007, the SEC issued SAB No. 110. SAB 110 allows for the continued use of a simplified method, as discussed in SAB No. 107, in developing an estimate of expected term of plain vanilla share options in accordance with SFAS 123 (revised 2004). Originally the SEC staff stated in SAB 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. Accordingly, the SEC staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Company will continue to use of the simplified method for determining the value of options granted as allowed by SAB 110.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS No. 141(R)) which establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS No. 141(R) also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users

Table of Contents

of the financial statements to evaluate the nature and financial effects of the business combination. The provisions of SFAS No. 141(R) are applicable to business combinations consummated on or after December 15, 2008 with early adoption prohibited.

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

*Reclassifications*

Certain amounts in the 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation. These reclassifications had no effect on the previously reported net loss or stockholders' deficit.

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have only recently begun to generate significant revenues and have incurred significant losses to date, and at June 30, 2008, we had an accumulated deficit of approximately \$56 million. In addition, broad commercial acceptance of our technology is critical to the Company's success and ability to generate future revenues.

If the Company is unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained by the Company in order to meet its needs, or that such financing would not be dilutive to existing shareholders.

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

3. DISCONTINUED OPERATIONS

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On May 22, 2007, the Company and ZOLL Data Systems, Inc. ( ZOLL ), a subsidiary of ZOLL Medical Corporation, entered into an Asset Purchase Agreement (the Purchase Agreement ), pursuant to which ZOLL acquired substantially all of the assets related to the Company's Fire/EMS Services division (the Fire Segment or Fire ).

At the closing of the sale, the Company received approximately \$1.8 million in cash, which represented the purchase price of \$7 million, less closing adjustments of approximately \$4.3 million, which was paid to the Senior Noteholder (see Note 9), approximately \$450,000, which was paid to the leaseholder of the Company's premises, \$400,000, which was placed in escrow pursuant to the Purchase Agreement, and approximately \$40,000 credited to Zoll on the assumption of certain liabilities.



Table of Contents

During the quarter ended September 30, 2007, \$250,000 of the escrow balance was released to ZOLL. The remaining escrow balance was remitted to the Company May 6, 2008. From the remaining balance, \$50,000 was paid as a settlement of a customer claim associated with the discontinued Fire business, and \$15,454 was paid as related professional fees to settle the claim which resulted in the \$65,454 loss .

Prior to the sale, Fire had been reported as a separate segment. The Company sold its Fire operating segment to better focus on its core lines of business. The Fire business has been reported as a discontinued operation in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and all periods presented have been recast accordingly to reflect these operations as discontinued.

Revenues and net income (loss) for the Fire Segment for the three and six month periods ended June 30, 2008 and 2007 were as follows:

|                   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|-------------------|---------------------------|-------------|-------------------------|-------------|
|                   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|                   | <b>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Revenues          | \$                        | 389,489     | \$                      | 1,546,746   |
| Net income (loss) |                           | (65,454)    |                         | 440,105     |

Table of Contents

## 4. SHARE BASED COMPENSATION

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

The compensation expense recognized under SFAS 123R increased the Company's loss from continuing operations by \$65,408 and \$168,007 with no effect per share (basic and diluted) for the three months ended June 30, 2008 and 2007 respectively, and \$332,201 and \$388,984 with a \$0.01 effect per share (basic and diluted), for the six months ended June 30, 2008 and 2007 respectively.

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/>2008</b> | <b>Three Months Ended<br/>June 30,<br/>2007</b> |
|---------------------------------------|---|---|
| Cost of services                      | \$ 2,666  | \$ 4,507  |
| Selling, general and administrative   | 47,749  | 126,879   |
| Research, development and engineering | 14,993  | 36,621  |
|                                       | <b>\$ 65,408</b>                                | <b>\$ 168,007</b>                               |

|                                       | <b>Six Months Ended<br/>June 30,<br/>2008</b> | <b>Six Months Ended<br/>June 30,<br/>2007</b> |
|---------------------------------------|---|---|
| Cost of services                      | \$ 13,639                                     | \$ 9,477                                      |
| Selling, general and administrative   | 232,934                                       | 298,198                                       |
| Research, development and engineering | 85,628  | 81,309  |
|                                       | <b>\$ 332,201</b>                             | <b>\$ 388,984</b>                             |

*Valuation Assumptions for Stock Options*

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For the three months ended June 30, 2008 and 2007, 564,272 and 64,000 stock options were granted, respectively. For the six months ended June 30, 2008 and 2007, 564,272 and 153,000 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:

Table of Contents

|                                     | Three Months Ended<br>June 30, |   |      |   |
|-------------------------------------|--------------------------------|---|------|---|
|                                     | 2008                           |   | 2007 |   |
| Risk free interest rate             | 2.95-3.72                      | % | 4.58 | % |
| Expected life of options (in years) | 4.5                            |   | 4.5  |   |
| Expected dividends                  | 0                              | % | 0    | % |
| Volatility of stock price           | 88                             | % | 86   | % |

|                                     | Six Months Ended<br>June 30, |   |           |   |
|-------------------------------------|------------------------------|---|-----------|---|
|                                     | 2008                         |   | 2007      |   |
| Risk free interest rate             | 2.95-3.72                    | % | 4.58-4.68 | % |
| Expected life of options (in years) | 4.5                          |   | 4.5       |   |
| Expected dividends                  | 0                            | % | 0         | % |
| Volatility of stock price           | 88                           | % | 86-87     | % |

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. The term of stock options granted may not exceed ten years. Options issued under the 1996 Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The 1996 Plan expired in May 2005.

*1999 Stock Option Plan*

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

*2004 Stock Option Plan*

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

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### Table of Contents

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

### *Non-Plan Stock Options*

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

### *Stock Option Activity*

The following table summarizes stock option activity for the six months ended June 30, 2008:

|  | 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, 2007               | 80,000        | 805,000        | 2,221,415         | 3,943,000        | 7,049,415        | \$ 0.85                         |  |                           |
| Granted  |               |                | 564,272           |                  | 564,272          | 0.11                            |  |                           |
| Exercised  |               |                |                   |                  |                  |                                 |  |                           |
| Forfeited  |               |                | (31,002)          |                  | (31,002)         | 0.51                            |  |                           |
| Expired  |               |                | (87,078)          | (48,000)         | (135,078)        | 2.83                            |  |                           |
| <b>Outstanding, as of June 30, 2008</b>            | <b>80,000</b> | <b>805,000</b> | <b>2,667,607</b>  | <b>3,895,000</b> | <b>7,447,607</b> | <b>0.76</b>                     | <b>3.44</b>                                | <b>\$ 21,831</b>          |
| <b>Vested or expected to vest at June 30, 2008</b> |               |                |                   |                  | <b>7,289,616</b> | <b>0.77</b>                     | <b>3.38</b>                                | <b>\$ 18,796</b>          |
| <b>Exercisable at June 30, 2008</b>                |               |                |                   |                  | <b>6,765,401</b> | <b>0.80</b>                     | <b>3.21</b>                                | <b>\$ 11,091</b>          |

The options outstanding and exercisable at June 30, 2008 were in the following exercise price ranges:

| Range of exercise prices | Number of shares | Options Outstanding             |  | Options Exercisable |                                 |
|--------------------------|------------------|---------------------------------|--|---------------------|---------------------------------|
|                          |                  | Weighted average exercise price | Weighted average remaining life (in years) | Number exercisable  | Weighted average exercise price |
| \$ 0.11-0.21             | 631,272          | \$ 0.12                         | 6.72                                       | 293,937             | \$ 0.19                         |
| 0.22-0.40                | 871,000          | 0.33                            | 1.45                                       | 837,330             | 0.33                            |
| 0.41-0.68                | 2,090,666        | 0.56                            | 2.91                                       | 1,779,465           | 0.55                            |

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|    |           |           |      |      |           |      |
|----|-----------|-----------|------|------|-----------|------|
|    | 0.69-1.11 | 2,183,169 | 0.90 | 4.13 | 2,183,169 | 0.97 |
|    | 1.12-1.62 | 1,671,500 | 1.30 | 2.98 | 1,671,500 | 1.44 |
| \$ | 0.11-1.62 | 7,447,607 |      |      | 6,765,401 |      |

The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.15 as of June 30, 2008, 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, 2008 was 564,272.

The weighted average fair value of options, as determined under SFAS No.123R, granted during the three months ended June 30, 2008 and June 30, 2007 was \$0.07 and \$0.14 per share, respectively, and during the six months ended June 30, 2008 and June 30, 2007 was \$0.07 and \$0.19 per share, respectively.

Table of Contents

As of June 30, 2008 future compensation cost related to nonvested stock options is approximately \$127,925 and will be recognized over an estimated weighted average period of approximately 1.26 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. For the three and six months ended June 30, 2008 and 2007, diluted per share computations are not presented since this effect would be antidilutive.

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, |                |
|--|-----------------------------|----------------|---------------------------|----------------|
|  | 2008                        | 2007           | 2008                      | 2007           |
| <b>Numerator:</b>  |                             |                |                           |                |
| Income (loss) from continuing operations                   | \$ 233,710                  | \$ (2,373,202) | \$ (681,959)              | \$ (3,760,065) |
| Convertible preferred stock dividends and accretion        | (470,893)                   | (471,518)      | (941,786)                 | (942,907)      |
| Income (loss) available to common stockholders (basic EPS) | \$ (237,183)                | \$ (2,844,720) | \$ (1,623,745)            | \$ (4,702,972) |
| Weighted-average shares used to compute diluted EPS        | 63,180,281                  | 58,067,198     | 62,483,507                | 57,354,818     |

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

|                                 | Three Months Ended |            | Six Months Ended |            |
|---------------------------------|--------------------|------------|------------------|------------|
|                                 | June 30,           | 2007       | June 30,         | 2007       |
|                                 | 2008               |            | 2008             |            |
| Preferred Stock                 | 33,155,440         | 19,926,204 | 33,155,440       | 19,939,051 |
| Convertible Debt                |                    | 4,906,320  |                  | 6,852,234  |
| Stock Options                   | 564,272            | 6,284      | 564,272          | 18,485     |
| Potentially dilutive securities | 33,719,712         | 24,838,808 | 33,719,712       | 26,809,770 |



Table of Contents

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

|               | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---------------|--------------------------------|------------|------------------------------|------------|
|               | 2008                           | 2007       | 2008                         | 2007       |
| Stock options | 6,883,335                      | 7,587,405  | 6,883,335                    | 7,587,405  |
| Warrants      | 10,566,375                     | 10,566,375 | 10,566,375                   | 10,566,375 |
| Total         | 17,449,710                     | 18,153,780 | 17,449,710                   | 18,153,780 |

## 6. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consisted of the following:

|  | June 30,<br>2008 | December 31,<br>2007 |
|--|------------------|----------------------|
| Equipment                                      | \$ 533,029       | \$ 517,658           |
| Furniture and fixtures                         | 148,494          | 187,984              |
| Software                                       | 136,355          | 136,355              |
| Leasehold improvements                         | 198,889          | 198,889              |
|  | 1,016,767        | 1,040,886            |
| Less accumulated depreciation and amortization | (903,391)        | (863,604)            |
| Total  | \$ 113,376       | \$ 177,282           |

## 7. GOODWILL AND OTHER INTANGIBLE ASSETS

The Company's goodwill resulted from the acquisition of Public Safety Group, Inc. and certain assets and assumed liabilities of the Mobile Government Division of Aether Systems, Inc. in 2004. As provided by SFAS No. 142, the Company has elected to perform the annual assessment of the carrying value of all goodwill as of September 30<sup>th</sup> of each year using a number of criteria, including the value of the overall enterprise. Impairment charges from existing operations or other acquisitions, if any, are reflected as an operating expense in the statement of operations. As of June 30, 2008 goodwill totaled \$7,836,986.

Other intangible assets as of June 30, 2008 consisted of the following:

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|                             | June 30, 2008         |                          |                     | December 31, 2007     |                          |                     |
|-----------------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                             | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Copyrighted software        | \$ 1,181,429          | \$ (1,004,215)           | \$ 177,214          | \$ 1,181,429          | \$ (886,071)             | \$ 295,358          |
| Customer relationships      | 617,271               | (462,953)                | 154,318             | 617,271               | (401,225)                | 216,046             |
| Trademarks                  | 807,872               | (643,885)                | 163,987             | 807,872               | (563,099)                | 244,773             |
| Developed technology        | 434,353               | (325,765)                | 108,588             | 434,353               | (282,330)                | 152,023             |
| Marketing agreements        | 605,340               | (514,539)                | 90,801              | 605,340               | (454,005)                | 151,335             |
| Patents and patents pending | 298,059               | (37,410)                 | 260,649             | 298,059               | (33,325)                 | 264,734             |
| <b>Total</b>                | <b>\$ 3,944,324</b>   | <b>\$ (2,988,767)</b>    | <b>\$ 955,557</b>   | <b>\$ 3,944,324</b>   | <b>\$ (2,620,055)</b>    | <b>\$ 1,324,269</b> |

Table of Contents

Aggregate amortization expense for the three months ended June 30, 2008 and 2007, was \$184,379 and \$185,521 respectively, and was \$368,712 and \$368,033 for the six months ended June 30, 2008 and 2007 respectively.

**8. INVESTMENTS**



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During 2005, BIO-key was issued shares in a private company, which specialized in providing security products and associated software. There was no cost to the investment for these shares, and because BIO-key had a minimal ownership interest in the company and was unable to exhibit any influence on the company's management or board, BIO-key treated the investment on the cost basis as promulgated under APB 18, *Equity Method of Accounting for Investments in Common Stock*.

In February 2008, the above mentioned private company consummated a reverse merger with a publicly traded US company. As a result of the merger, BIO-key's investment was converted into shares of the public company. This change in circumstances enabled the fair value of the investment to be readily determinable under the provisions of FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, BIO-key now classifies its investment as an available-for-sale security, and accounts for it at its market value as specified on a securities exchange.

Unrealized gains and temporary losses on investments classified as available-for-sale are included within accumulated other comprehensive income, net of any related tax effect. Upon realization, those amounts are reclassified from accumulated other comprehensive income to investment income. Realized gains and losses and other than temporary impairments on investments are reflected in the income statement in investment income or expense. Gains or losses are calculated primarily using the first-in, first-out method.

The following table summarizes our investment at June 30, 2008 and December 31, 2007. The investment is classified within current assets in the balance sheet. Fair value for publicly-traded available-for-sale investments is determined based upon quoted prices. Fair value is not readily available for privately-held investments.

|                             | June 30, 2008 |            | December 31, 2007 |            |
|-----------------------------|---------------|------------|-------------------|------------|
|                             | Cost          | Fair Value | Cost              | Fair Value |
| Available-for-sale security | \$            | \$ 276,013 | \$                | \$         |
| Balance as of June 30, 2008 | \$            | \$ 276,013 | \$                | \$         |

Unrealized gain on the available-for-sale security was \$276,013 at June 30, 2008.

### 9. CONVERTIBLE DEBT FINANCING / WARRANTS

Long-term obligations consisted of the following as of:

|                 | June 30,<br>2008 | December 31,<br>2007 |
|-----------------|------------------|----------------------|
| <b>2004</b>     |                  |                      |
| FMV of warrants | \$ 23,395        | \$ 11,663            |
| <b>2005</b>     |                  |                      |
| FMV of warrants | 52,730           | 34,644               |
| <b>2006</b>     |                  |                      |
| FMV of warrants | 28,927           | 18,213               |
| <b>Total</b>    | \$ 105,052       | \$ 64,520            |



Table of Contents

*Senior Convertible Term Notes*

**2004 and 2005 Senior Notes**

On September 29, 2004, the Company entered into a Securities Purchase Agreement (the "2004 Senior Purchase Agreement") with Laurus Master Fund, Ltd. ("Laurus") to issue secured convertible term notes in the aggregate principal amount of \$5,050,000. On June 8, 2005, we entered into a second Securities Purchase Agreement (the "2005 Senior Purchase Agreement") with Laurus.

On May 22, 2007, the Company used approximately \$4,300,000 of the net cash proceeds received in connection with the sale of the Fire Segment (see Note 3) to repay in full its obligations to Laurus under the 2004 and 2005 Senior Notes.

The account balance shown represents the fair market value of warrants issued in conjunction with debt offerings undertaken from the 2004 to 2006 fiscal years. The Warrants are classified as liabilities and were valued as of June 30, 2008, using the Black Scholes Option Pricing model with the following assumptions: dividend yield of 0%; annual volatility of 91% to 108% and risk-free interest rate of 2.4% to 2.8%.

**2004 and 2005 Senior Note Derivatives and Discounts**

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

Following the repayment of the 2004 and 2005 Senior Notes on May 22, 2007, the value of the embedded derivatives and amortized discounts related to the Notes were written off to Loss on Extinguishment of Debt.

10. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

|  | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|--|--------------------------|------------------------------|
| Contract costs not yet invoiced by vendors | \$ 91,888                | \$ 2,185,610                 |

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|                      |              |              |
|----------------------|--------------|--------------|
| Compensation         | 94,733       | 140,314      |
| Compensated absences | 395,237      | 367,731      |
| Royalties            | 347,570      | 371,158      |
| Interest             | 176,083      | 176,083      |
| Other                | 170,832      | 160,853      |
| Total                | \$ 1,276,343 | \$ 3,401,749 |



Table of Contents

11. REDEEMABLE PREFERRED STOCK

**Series B Convertible Preferred Stock**

The Company issued 1,000,000 shares of redeemable Series B Convertible Preferred Stock on February 23, 2006, upon the conversion of certain convertible term notes. Each share of Series B Preferred Stock has an Original Issue Price of \$1.00 per share. The holder has the option to redeem the shares of Series B Preferred Stock at any time for a number of shares of the Company's common stock equal to the Original Issue Price plus accumulated and unpaid dividends divided by the fixed conversion price of \$0.30 per share of Common. The conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series B Preferred Stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price less than the conversion price. Mandatory conversion of all Series B shares will be automatic if, for the 30 trading days prior to January 1, 2009, the average closing bid price for one share of common stock is at least \$1.10. The shares shall be converted at the conversion price then in effect. If the average bid price for the 30 trading days prior to January 1, 2009 per common share is less than \$1.10 the Company shall mandatorily redeem all remaining outstanding Series B Preferred Stock by paying cash equal to \$1.00 per share with all accrued and unpaid dividends. The Company may, at its election, redeem any or all of the remaining outstanding Series B shares in cash at a conversion price equal to \$1.20 per share, together with all accrued and unpaid dividends upon giving 30 day notice. Holders of the Series B Preferred Stock are entitled to cumulative, prior and in preference to holders of common stock dividends equal to 15% per annum of the Original Purchase Price still outstanding, payable quarterly. In any liquidation of the Company, each share of Preferred Stock is entitled to a liquidation preference on a pari passu basis with the Series A and Series C Preferred Stock before any distribution may be made on the Company's common stock.

As of June 30, 2008, 1,000,000 shares of Series B Preferred Stock were authorized, 970,612 of which were issued and outstanding, at a par value of \$0.0001 and a liquidation preference of \$1.00 with accumulated dividends in arrears of \$36,802, which have been accreted to the principal balance of the Series B preferred stock.

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

As of June 30, 2008 the derivatives were valued at \$1,811. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 15%; annual volatility of 49%; and risk free annual interest rate of 2.17% as well as probability analysis related to trading volume restrictions.

An amount equal to the original value of the derivatives was recorded as a discount to the Preferred Stock. The discount is being accreted to the principal balance of the Preferred Stock, using the effective interest method, over the expected term of the Preferred Stock. At June 30, 2008, the unamortized discount on the Preferred Stock was \$63,240.

**Series C Convertible Preferred Stock**

The Company issued 592,032 shares of redeemable Series C Convertible Preferred Stock on August 10, 2006, upon the exchange of certain convertible term notes. Each share of Series C Preferred Stock has an Original Issue Price of \$10.00 per share. The holder has the option to redeem the shares of Series C Preferred Stock at any time for a number of shares of the Company's common stock equal to the Original Issue Price plus accumulated and unpaid dividends divided by the fixed conversion price of \$0.30 per share of Common Stock. The conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series C Preferred Stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price less than the conversion price. Mandatory conversion of all Series C shares will be automatic if, for

Table of Contents

the 30 trading days prior to January 1, 2009, the average closing bid price for one share of common stock is at least \$1.20. The shares shall be converted at the conversion price then in effect. If the average bid price for the 30 trading days prior to January 1, 2009 per common share is less than \$1.20 the Company shall mandatorily redeem all remaining outstanding Series C preferred stock by paying cash equal to \$10.00 per share with all accrued and unpaid dividends. The Company may, at its election, redeem any or all of the remaining outstanding Series C shares in cash at a conversion price equal to \$12.00 per share, together with all accrued and unpaid dividends upon giving 30 day notice. Holders of the Series C preferred stock are entitled to cumulative, prior and in preference to holders of common stock dividends equal to 15% per annum of the Original Purchase Price still outstanding, payable quarterly. In any liquidation of the Company, each share of Preferred Stock is entitled to a liquidation preference on a pari passu basis with the Series A and Series B Preferred Stock before any distribution may be made on the Company's common stock.

As of June 30, 2008, 600,000 Shares of Series C Preferred Stock were authorized, 592,032 of which were issued and outstanding, at a par value of \$0.0001 and a liquidation preference of \$10.00 with accumulated dividends in arrears of \$532,219, which have been accreted to the principal balance of the Series C Preferred Stock.

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

As of June 30, 2008 the derivatives were valued at \$10,126. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 15%; annual volatility of 49%; and risk free annual interest rate of 2.17% as well as probability analysis related to trading volume restrictions.

An amount equal to the original value of the derivatives was recorded as a discount to the Preferred Stock. The discount is being accreted to the principal balance of the Preferred Stock, using the effective interest method, over the expected term of the Preferred Stock. At June 30, 2008, the unamortized discount on the Preferred Stock was \$224,722.

Together with the above transaction, the terms of certain warrants held by the Company's investment bankers and their associates were modified. The incremental value of the modification was calculated to be \$110,453, and was allocated against the proceeds of the Series C Convertible Preferred Stock as a cost of financing, and is being accreted to the principal balance of the Preferred Stock, using the effective interest method, over the expected term of the term of the Preferred Stock. At June 30, 2008, the net amount remaining to be accreted was \$23,123.

12. STOCKHOLDERS EQUITY

Common Stock

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The Company is authorized to issue 170,000,000 shares of common stock, \$.0001 par value per share, of which 63,913,383 were outstanding as of June 30, 2008.

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

Table of Contents

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

During the three months and the six months ended June 30, 2008, preferred stockholders converted accumulated dividends of \$171,705 into 1,402,211 shares and accumulated dividends of \$342,349 into 2,760,181 shares of the Company's common stock respectively.

Series A Convertible Preferred Stock

Within the limits and restrictions provided in the Company's Certificate of Incorporation, the Board of Directors has the authority, without further action by the shareholders, to issue up to 5,000,000 shares of preferred stock, \$.0001 par value per share, in one or more series, and to fix, as to any such series, any dividend rate, redemption price, preference on liquidation or dissolution, sinking fund terms, conversion rights, voting rights, and any other preference or special rights and qualifications.

In March 2004, we designated 100,000 shares of preferred stock as Series C Convertible Preferred Stock. In connection with the Company's reincorporation in Delaware on January 1, 2005, each share of Series C Convertible Preferred Stock was automatically converted into one share of Series A Convertible Preferred Stock (the Series A Shares), of which 30,557 were issued and outstanding June 30, 2008.

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

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

As of June 30, 2008, cumulative dividends in arrears related to the Series A preferred stock were approximately \$352,091, which have been accreted to the principal balance of the Series A preferred stock.

Warrants

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

Table of Contents

|   | Total Warrants | Weighted average exercise price | Weighted average remaining life (in years) | Aggregate intrinsic value |
|---|----------------|---------------------------------|--|---------------------------|
| Outstanding, as of December 31, 2007        | 10,566,375     | \$ 0.95                         |  |                           |
| Granted                                     |                |                                 |  |                           |
| Exercised                                   |                |                                 |  |                           |
| Expired                                     |                |                                 |  |                           |
| Outstanding, as of June 30, 2008            | 10,566,375     | 0.95                            | 1.52                                       | \$                        |
| Vested or expected to vest at June 30, 2008 | 10,566,375     | 0.95                            | 1.52                                       |                           |
| Exercisable at June 30, 2008                | 10,566,375     | 0.95                            | 1.52                                       |                           |

The warrants outstanding and exercisable at June 30, 2008 were in the following exercise price ranges:

| Range of exercise prices | Warrants outstanding and Exercisable<br>Number of warrants | Weighted average remaining life (in years) |
|--------------------------|--|--|
| \$ 0.30                  | 2,798,014  | 2.61                                       |
| 0.75                     | 533,333  | 3.11                                       |
| 0.97                     | 150,000  | 1.04                                       |
| 1.00                     | 2,655,552  | 1.37                                       |
| 1.35                     | 4,429,476  | .75  |
|                          | 10,566,375   |  |

As part of sale of the Fire business to ZOLL, and repayment of the Company's convertible debt, both in May 2007, the exercise price of certain warrants was adjusted to \$0.30 per share. The incremental fair value of the modification of \$33,817 was allocated to interest expense as a cost of financing.

13. COMPREHENSIVE LOSS

The component of accumulated other comprehensive income was as follows:

|  | June 30, 2008 |
|--|---------------|
| Unrealized gain on available-for-sale securities, net of tax | \$ 276,013    |
| Total accumulated other comprehensive income                 | \$ 276,013    |

The components of comprehensive income (loss) for the six months ended June 30, 2008 and 2007 were as follows:

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|   | <b>June 30,<br/>2008</b> | <b>June 30,<br/>2007</b> |
|---|--------------------------|--------------------------|
| Net Profit (loss)                         | \$ (747,413)             | \$ 750,899               |
| Unrealized gain on securities, net of tax | 276,013                  |                          |
| Total comprehensive income (loss)         | \$ (471,400)             | \$ 750,899               |



Table of Contents

## 14. SEGMENT INFORMATION

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

Prior to the sale of the Fire business in May 2007, Fire had been reported as a separate segment. Prior periods presented have been recast accordingly to reflect these operations as discontinued. Geographically, North American sales accounted for approximately 99% and 100% of the Company's total sales for the three month periods and 98% and 100% for the six month periods ended June 30, 2008 and 2007 respectively.

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

|   | Three Months Ended<br>June 30, |                     | Six Months Ended<br>June 30, |                    |
|---|--------------------------------|---------------------|------------------------------|--------------------|
|   | 2008                           | 2007                | 2008                         | 2007               |
| <b>Revenue:</b>                                     |                                |                     |                              |                    |
| Law   | \$ 2,358,677                   | \$ 2,309,407        | \$ 4,546,476                 | \$ 4,907,078       |
| Biometrics  | 1,221,276                      | 153,452             | 1,573,895                    | 271,021            |
| Consolidated Revenue                                | \$ 3,579,953                   | \$ 2,462,859        | \$ 6,120,371                 | \$ 5,178,099       |
| <b>Segment operating profit/(loss)</b>              |                                |                     |                              |                    |
| Law   | (319,600)                      | (998,399)           | (1,018,402)                  | (2,045,676)        |
| Biometrics  | 618,852                        | (534,477)           | 380,468                      | (1,159,013)        |
| Total Segment Operating Income (Loss)               | 299,252                        | (1,532,876)         | (637,934)                    | (3,204,689)        |
| <b>Reconciliation to net loss</b>                   |                                |                     |                              |                    |
| Derivative and warrant fair value adjustments       | (41,915)                       | (158,916)           | (11,174)                     | 670,452            |
| Interest income                                     | 399                            | 1,331               | 1,298                        | 1,331              |
| Interest expense                                    | (7,884)                        | (260,801)           | (18,007)                     | (799,317)          |
| Loss on extinguishment of debt                      |                                | (403,940)           |                              | (403,940)          |
| Other expense                                       | (16,142)                       | (18,000)            | (16,142)                     | (23,902)           |
| <b>Net income (loss) from continuing operations</b> | <b>233,710</b>                 | <b>(2,373,202)</b>  | <b>(681,959)</b>             | <b>(3,760,065)</b> |
| Income (loss) from discontinued operations          | (65,454)                       | (34,385)            | (65,454)                     | 440,105            |
| Gain on disposal of discontinued operations         |                                | 4,070,859           |                              | 4,070,859          |
| <b>Net income (loss)</b>                            | <b>\$ 168,256</b>              | <b>\$ 1,663,272</b> | <b>\$ (747,413)</b>          | <b>\$ 750,899</b>  |

Table of Contents

15. INCOME TAXES

On January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48 *Accounting for the Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* ( FIN No. 48 ). FIN No. 48 requires that the impact of tax positions be recognized in the financial statements if they are more likely than not of being sustained based on the technical merits of the position. The Company has a valuation allowance against the full amount of its net deferred taxes. The Company currently provides a valuation allowance against deferred taxes when it is more likely than not that some portion, or all of its deferred tax assets will not be realized.

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

The Company has not been audited by the Internal Revenue Service ( IRS ) or any states in connection with income taxes. The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The periods from 2004-2007 remain open to examination by the IRS and state jurisdictions. The Company believes it is not subject to any tax risk beyond the preceding discussion. The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. The Company does not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the three and six months ended June 30, 2008 and 2007.

16. SUBSEQUENT EVENTS

On July 28, 2008, the Company entered into an Office Lease Agreement, effective as of June 30, 2008 (the Lease ), with a new landlord (the Landlord ) to lease office space located at 300 Nickerson Road, Marlborough, Massachusetts and consisting of approximately 14,907 square feet. Since September 20, 2004, the Company has subleased approximately 38,000 square feet of space at this location pursuant to a Sublease (the Sublease ) as subtenant. The Sublease will expire in accordance with its terms on August 31, 2008. The term of the Lease will commence on September 1, 2008 and will end on August 31, 2011. Under the Lease, the Company will be required to make monthly rental payments of \$20,250 from September 1, 2008 through August 31, 2009, \$26,398 from September 1, 2009 through August 31, 2010 and \$27,640 from September 1, 2010 through August 31, 2011. The Lease also provides for the payment of certain additional rent to the Landlord for certain operating expenses and taxes. Upon execution of the Lease, the Company delivered a security deposit to the Landlord in the form of an irrevocable letter of credit in the amount of \$40,500.

Also on July 28, 2008, the Company entered into a Settlement and Mutual Release Agreement (the Settlement Agreement ) with a vendor in order to resolve all matters relating to invoices totaling approximately \$2,350,000 that the Company received in January 2008 for materials that had been delivered by the vendor, as a subcontractor on a long-term project for which the Company had served as the prime contractor. Pursuant to the Settlement Agreement, the parties agreed to a payment schedule under which the Company will be required to satisfy this outstanding balance, plus interest at seven percent (7%) per annum on the unpaid portion of the balance, in full on or before June 1, 2009. In return, the vendor agreed to forbear from exercising any of its rights and remedies against the Company with respect to these amounts so long as the Company remains in compliance with its obligations under of the Settlement Agreement.



Table of Contents

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

**CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS**



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

Many of these factors are set forth in the Company's Annual Report on Form 10-KSB 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**



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

On March 30, 2004, BIO-key acquired Public Safety Group, Inc. (PSG), a privately held company that was a leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology was PocketCop, a handheld solution that provides mobile police officers, such as detectives who are not typically in their vehicles, a hand-held mobile information software solution.

On September 30, 2004, BIO-key acquired Aether Systems, Inc.'s Mobile Government Division ( Mobile Government or AMG ), a leading provider of wireless data solutions for use by public safety organizations, primarily state, local police, fire and rescue and emergency medical services organizations. Our PacketCluster mobile information software, originally acquired as part of this transaction, is integrated with 50 separate State/NCIC databases, as well as other state, local and federal databases. Its open architecture and its published Application Programming Interface (API) make it easy to interface with a wide range of information sources. PacketCluster products deliver real-time information in seconds, freeing dispatchers to handle more pressing emergencies.

On May 22, 2007, BIO-key completed a transaction with ZOLL Data Systems, Inc. ( ZOLL ), a subsidiary of ZOLL Medical Corporation, in which ZOLL acquired substantially all of the assets related to the Company's Fire/EMS Services division.



Table of Contents

**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-KSB, for the fiscal year ended December 31, 2007. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-KSB filed on March 26, 2008.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which is effective for calendar year companies on January 1, 2008. This Statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. Management has adopted SFAS 157. The adoption of SFAS 157 had no impact on the Company's financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which is effective for calendar year companies on January 1, 2008. The statement allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 further establishes certain additional disclosure requirements. The adoption of SFAS 159 had no impact on the Company's financial condition and results of operations.

In December 2007, the SEC issued SAB No. 110. SAB 110 allows for the continued use of a simplified method, as discussed in SAB No. 107, in developing an estimate of expected term of plain vanilla share options in accordance with SFAS 123 (revised 2004). Originally the SEC staff stated in SAB 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. Accordingly, the SEC staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Company will continue to use of the simplified method for determining the value of options granted as allowed by SAB 110.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS No. 141(R)) which establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS No. 141(R) also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The provisions of SFAS No. 141(R) are applicable to business combinations consummated on or after December 15, 2008 with early adoption prohibited.

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



Table of Contents

**RESULTS OF OPERATIONS**

**THREE MONTHS ENDED JUNE 30, 2008**

AS COMPARED TO JUNE 30, 2007



**INTRODUCTION**



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

Over the past few years, the Company has integrated the products, operations and technology acquired from PSG and AMG and restructured its operations into three business segments: Biometrics, Law Enforcement and Fire Safety, the last of which was sold in May 2007 to ZOLL. Our Biometrics and Law Enforcement segments are headed by a General Manager and are organized to quickly respond to market needs as well as to drive down costs to achieve profitability.

A detailed analysis of both segments can be found below.

### **Consolidated Results of Operations - Percent Trend**

|   | <b>Three Months Ended June 30,</b> |             |
|---|------------------------------------|-------------|
|   | <b>2008</b>                        | <b>2007</b> |
| <b>Revenues</b>                                     |                                    |             |
| Services  | 51%                                | 69%         |
| License fees and other                              | 49%                                | 31%         |
|   | 100%                               | 100%        |
| <b>Costs and other expenses</b>                     |                                    |             |
| Cost of services                                    | 8%                                 | 16%         |
| Cost of license fees and other                      | 4%                                 | 3%          |
|   | 12%                                | 19%         |
| Gross Profit  | 88%                                | 81%         |
| <b>Operating expenses</b>                           |                                    |             |
| Selling, general and administrative                 | 47%                                | 90%         |
| Research, development and engineering               | 33%                                | 53%         |
|   | 80%                                | 143%        |
| <b>Operating Income (Loss)</b>                      | <b>8%</b>                          | <b>-62%</b> |
| <b>Other deductions</b>                             |                                    |             |
| Total other deductions                              | -1%                                | -34%        |
| <b>Net Income (Loss) from continuing operations</b> | <b>7%</b>                          | <b>-96%</b> |
| <b>Net Loss from discontinued operations</b>        | <b>-2%</b>                         | <b>-1%</b>  |
| <b>Gain on disposal of discontinued operations</b>  |                                    | <b>165%</b> |
| <b>Net Income</b>                                   | <b>5%</b>                          | <b>68%</b>  |

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



Table of Contents

|                           | Three months ended<br>June 30, |              |              |          |
|---------------------------|--------------------------------|--------------|--------------|----------|
|                           | 2008                           | 2007         | \$ Change    | % Change |
| <b>Revenues</b>           |                                |              |              |          |
| <b>Law Enforcement</b>    |                                |              |              |          |
| Service                   | \$ 1,781,915                   | \$ 1,688,112 | \$ 93,803    | 6%       |
| License & other           | 576,762                        | 621,295      | (44,533)     | -7%      |
|                           | 2,358,677                      | 2,309,407    | 49,270       | 2%       |
| <b>Biometrics</b>         |                                |              |              |          |
| Service                   | 46,430                         | 9,355        | 37,075       | 396%     |
| License & other           | 1,174,846                      | 144,097      | 1,030,749    | 715%     |
|                           | 1,221,276                      | 153,452      | 1,067,824    | 696%     |
| <b>Total Revenue</b>      | \$ 3,579,953                   | \$ 2,462,859 | \$ 1,117,094 | 45%      |
| <b>Cost of goods sold</b> |                                |              |              |          |
| <b>Law Enforcement</b>    |                                |              |              |          |
| Service                   | \$ 270,107                     | \$ 362,339   | \$ (92,232)  | -25%     |
| License & other           | 103,908                        | 29,588       | 74,320       | 251%     |
|                           | 374,015                        | 391,927      | (17,912)     | -5%      |
| <b>Biometrics</b>         |                                |              |              |          |
| Service                   | 18,641                         | 37,240       | (18,599)     | -50%     |
| License & other           | 28,522                         | 34,105       | (5,583)      | -16%     |
|                           | 47,163                         | 71,345       | (24,182)     | -34%     |
| <b>Total COGS</b>         | \$ 421,178                     | \$ 463,272   | \$ (42,094)  | -9%      |

**Revenues**Law Enforcement

Service revenue for the segment for the three month period ended June 30, 2008 increased by 6% as a result of increased maintenance revenue from new orders.

Although license & other revenue for the three month period ended June 30, 2008 decreased 7% from the same period in 2007, the 2007 revenue included \$310,000 from a cash payment that the Company received from a long-term project it had participated in as a subcontractor. Eliminating the effect of this revenue, license and other revenue for the three month period ended June 30, 2008 increased approximately \$265,000 due to the receipt of a \$243,000 order from an existing customer.

Biometrics

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For the three months ended June 30, 2008, Service revenue increased \$37,000 from the same period in 2007 as the Company added new maintenance customers.

License and other revenue for the three months ended June 30, 2008 increased \$1,031,000 largely as a result of revenue generated from a new OEM customer, as well as additional license revenue from existing customers.

Table of Contents*Costs of goods sold*Law Enforcement

Cost of services for the three months ended June 30, 2008 decreased approximately \$92,000 from the same period in 2007 due to lower personnel related expenses.

Cost of licenses for the three months ended June 30, 2008 increased by approximately \$74,000 from the same period in 2007 due to an increase in third-party software and royalty costs.

Biometrics

For the three months ended June 30, 2008, cost of services decreased approximately \$19,000 from the same period in 2007 due to lower personnel related expenses. The Company expects these costs will increase in future periods as additional Biometric customers are added.

License and other costs decreased for the three months ended June 30, 2008 from the same period in 2007 by approximately \$6,000 as a result of reduced hardware costs

*Selling, general and administrative*

|                        | Three months ended<br>June 30, |              |              |          |
|------------------------|--------------------------------|--------------|--------------|----------|
|                        | 2008                           | 2007         | \$ Change    | % Change |
| <b>Law Enforcement</b> | \$ 1,413,216                   | \$ 1,857,826 | \$ (444,610) | -24%     |
| <b>Biometrics</b>      | 282,090                        | 354,655      | (72,565)     | -20%     |
| <b>Total</b>           | \$ 1,695,306                   | \$ 2,212,481 | \$ (517,175) | -23%     |

Law Enforcement & Biometrics

SG&A expenses decreased by 23% for the three months ended June 30, 2008 from the same period in 2007 due to lower personnel related expenses, stock compensation charges and fees for professional services. The Company expects that SG&A expenses will remain at approximately the same level for the remainder of 2008.

*Research, development and engineering*

|                        | Three months ended |                  | \$ Change    | % Change |
|------------------------|--------------------|------------------|--------------|----------|
|                        | 2008               | June 30,<br>2007 |              |          |
| <b>Law Enforcement</b> | \$ 891,047         | \$ 1,058,054     | \$ (167,007) | -16%     |
| <b>Biometrics</b>      | 273,170            | 261,928          | 11,242       | 4%       |
| <b>Total</b>           | \$ 1,164,217       | \$ 1,319,982     | \$ (155,765) | -12%     |

Table of ContentsLaw Enforcement & Biometrics

Research, development and engineering expenses decreased by 12% for the three months ended June 30, 2008 from the same period in the prior year, driven largely by reductions in facilities and personnel related expenses.

*Other income and expense*

|  | Three months ended<br>June 30, |              |    |         |          |
|--|--------------------------------|--------------|----|---------|----------|
|  | 2008                           | 2007         | \$ | Change  | % Change |
| <b>Derivative and warrant fair value adjustments</b> | \$ (41,915)                    | \$ (158,916) | \$ | 117,001 | -74%     |
| <b>Interest income</b>                               | 399                            | 1,331        |    | (932)   | -70%     |
| <b>Interest expense</b>                              | (7,884)                        | (260,801)    |    | 252,917 | -97%     |
| <b>Loss on extinguishment of debt</b>                |                                | (403,940)    |    | 403,940 | -100%    |
| <b>Other income (expense)</b>                        | (16,142)                       | (18,000)     |    | 1,858   | -10%     |
| <b>Total</b>   | \$ (65,542)                    | \$ (840,326) | \$ | 774,784 | -92%     |

For the quarter ended June 30, 2008, derivative and warrant fair value adjustments increased, when compared to the 2007 period, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt issued in 2004 and 2005, as well as additional derivatives recorded as a result of financings in 2006. 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 instruments at different points in time.

For the quarter ended June 30, 2008, interest expense decreased \$253,000 as compared to the same quarter in 2007. The decrease was attributable the repayment of all debt in May 2007. Interest expense includes actual cash paid for interest as well as non-cash charges for amortization of debt discounts and deferred charges.

The balance of unamortized debt discounts, deferred financing charges, and derivatives with respect to the 2004 and 2005 financings were extinguished as part of the May 2007 debt repayment. The changes represented non-cash income and expense charges to the statement of operations, and were classified as loss on extinguishment of debt. There was no extinguishment of debt for the quarter ended June 30, 2008.

Table of Contents**SIX MONTHS ENDED JUNE 30, 2008 AS COMPARED TO JUNE 30, 2007****Consolidated Results of Operations - Percent Trend**

|   | Six Months Ended June 30, |             |
|---|---------------------------|-------------|
|   | 2008                      | 2007        |
| <b>Revenues</b>                                       |                           |             |
| Services  | 58%                       | 69%         |
| License fees and other                                | 42%                       | 31%         |
|   | 100%                      | 100%        |
| <b>Costs and other expenses</b>                       |                           |             |
| Cost of services                                      | 10%                       | 16%         |
| Cost of license fees and other                        | 4%                        | 2%          |
|   | 14%                       | 18%         |
| Gross Profit  | 86%                       | 82%         |
| <b>Operating expenses</b>                             |                           |             |
| Selling, general and administrative                   | 57%                       | 92%         |
| Research, development and engineering                 | 39%                       | 52%         |
|   | 96%                       | 144%        |
| <b>Operating loss</b>                                 | <b>-10%</b>               | <b>-62%</b> |
| <b>Other deductions</b>                               |                           |             |
| Total other deductions                                | -1%                       | -10%        |
| <b>Net Loss from continuing operations</b>            | <b>-11%</b>               | <b>-72%</b> |
| <b>Net Income (Loss) from discontinued operations</b> | <b>-1%</b>                | <b>8%</b>   |
| <b>Gain on disposal of discontinued operations</b>    |                           | <b>79%</b>  |
| <b>Net Income (Loss)</b>                              | <b>-12%</b>               | <b>15%</b>  |

Table of Contents

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

|                           | Six months ended<br>June 30, |              |              |          |
|---------------------------|------------------------------|--------------|--------------|----------|
|                           | 2008                         | 2007         | \$ Change    | % Change |
| <i>Revenues</i>           |                              |              |              |          |
| <b>Law Enforcement</b>    |                              |              |              |          |
| Service                   | \$ 3,466,069                 | \$ 3,541,446 | \$ (75,377)  | -2%      |
| License & other           | 1,080,407                    | 1,365,632    | (285,225)    | -21%     |
|                           | 4,546,476                    | 4,907,078    | (360,602)    | -7%      |
| <b>Biometrics</b>         |                              |              |              |          |
| Service                   | 79,545                       | 31,197       | 48,348       | 155%     |
| License & other           | 1,494,350                    | 239,824      | 1,254,526    | 523%     |
|                           | 1,573,895                    | 271,021      | 1,302,874    | 481%     |
| <i>Total Revenue</i>      | \$ 6,120,371                 | \$ 5,178,099 | \$ 942,272   | 18%      |
| <i>Cost of goods sold</i> |                              |              |              |          |
| <b>Law Enforcement</b>    |                              |              |              |          |
| Service                   | \$ 607,343                   | \$ 770,180   | \$ (162,837) | -21%     |
| License & other           | 158,604                      | 48,223       | 110,381      | 229%     |
|                           | 765,947                      | 818,403      | (52,456)     | -6%      |
| <b>Biometrics</b>         |                              |              |              |          |
| Service                   | 28,990                       | 77,288       | (48,298)     | -62%     |
| License & other           | 67,722                       | 46,381       | 21,341       | 46%      |
|                           | 96,712                       | 123,669      | (26,957)     | -22%     |
| <i>Total COGS</i>         | \$ 862,659                   | \$ 942,072   | \$ (79,413)  | -8%      |

*Revenues*Law Enforcement

For the six months ended June 30, 2008, service revenue decreased by 2% from the same period in 2007. Service revenue for the six months ended June 30, 2007 included \$293,000 from a long-term project that the Company had participated in as a subcontractor.

License & other revenue for the six months ended June 30, 2008 declined by 21% from the same period in the prior year. For the six month period ended June 30, 2007 License & other revenue included \$310,000 from a cash payment that the Company received for the above mentioned project.

Biometrics

Service revenue for the six months ended June 30, 2008 increased 155% as the Company has added new maintenance customers during the period.

License & other revenue increased 523% as a result of revenue generated from a new OEM customer, as



Table of Contents

well as additional license revenue from existing customers.

***Costs of goods sold****Law Enforcement*

Cost of services for the six months ended June 30, 2008 decreased 21% from the same period in 2007 due to lower personnel related expenses.

Cost of License & other for the six months ended June 30, 2008 increased by \$110,381 from the six months ended June 30, 2007 as a result of an increase in third-party software royalty costs.

*Biometrics*

Cost of services decreased 62% from the same period in 2007 due to lower personnel related expenses. The Company expects these costs will increase in future periods as additional Biometric customers are added.

Costs of License and other for the six months ended June 30, 2008 increased 46% due to an increase in hardware costs.

***Selling, general and administrative***

|                        | Six months ended<br>June 30, |              |                |          |
|------------------------|------------------------------|--------------|----------------|----------|
|                        | 2008                         | 2007         | \$ Change      | % Change |
| <b>Law Enforcement</b> | \$ 2,922,867                 | \$ 4,019,178 | \$ (1,096,311) | -27%     |
| <b>Biometrics</b>      | 561,531                      | 744,598      | (183,067)      | -25%     |
| <b>Total</b>           | \$ 3,484,398                 | \$ 4,763,776 | \$ (1,279,378) | -27%     |

SG&A costs for the six months ended June 30, 2008 decreased 27% compared to the same period in 2007. For the six months ended June 30, 2007, the Company incurred \$426,000 in legal and regulatory costs associated with the failed acquisition of a Canadian company. Also contributing to the decline were lower personnel related expenses, stock compensation charges and fees for professional services.

*Research, development and engineering*

|                        | Six months ended<br>June 30, |              |              |          |
|------------------------|------------------------------|--------------|--------------|----------|
|                        | 2008                         | 2007         | \$ Change    | % Change |
| <b>Law Enforcement</b> | \$ 1,876,062                 | \$ 2,115,175 | \$ (239,113) | -11%     |
| <b>Biometrics</b>      | 535,186                      | 561,765      | (26,579)     | -5%      |
| <b>Total</b>           | \$ 2,411,248                 | \$ 2,676,940 | \$ (265,692) | -10%     |

Table of ContentsLaw Enforcement & Biometrics

For the six months ended June 30, 2008, R & D costs decreased 10% from the six months ended June 30, 2007 due to reductions in facilities and personnel related expenses.

*Other income and expense*

|  | Six months ended<br>June 30, |              |              |          |
|--|------------------------------|--------------|--------------|----------|
|  | 2008                         | 2007         | \$ Change    | % Change |
| <b>Derivative and warrant fair value adjustments</b> | \$ (11,174)                  | \$ 670,452   | \$ (681,626) | -102%    |
| <b>Interest income</b>                               | 1,298                        | 1,331        | (33)         | -2%      |
| <b>Interest expense</b>                              | (18,007)                     | (799,317)    | 781,310      | -98%     |
| <b>Loss on extinguishment of debt</b>                |                              | (403,940)    | 403,940      | -100%    |
| <b>Other income (expense)</b>                        | (16,142)                     | (23,902)     | 7,760        | -32%     |
| <b>Total</b>   | \$ (44,025)                  | \$ (555,376) | \$ 511,351   | -92%     |

For the six months ended June 30, 2008, derivative and warrant fair value adjustments decreased, when compared to the 2007 period, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt issued in 2004 and 2005, as well as additional derivatives recorded as a result of financings in 2006. 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 instruments at different points in time.

For the six months ended June 30, 2008, interest expense decreased 98% as compared to the same quarter in 2007. The decrease was attributable to reductions in convertible debt, related discount and other debt related instruments due to the Company restructuring in August 2006, the expiration of the letter of credit arrangement with Aether Systems Inc. on December 31, 2006, and the repayment of all debt in May 2007. Interest expense includes actual cash paid for interest as well as non-cash charges for amortization of debt discounts and deferred charges.

The balance of unamortized debt discounts, deferred financing charges, and derivatives with respect to the 2004 and 2005 financings were extinguished as part of the May 2007 debt repayment. The changes represented non-cash income and expense charges to the statement of operations and were classified as loss on extinguishment of debt.

**LIQUIDITY AND CAPITAL RESOURCES**

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For the six months ended June 30, 2008, net cash used in operations was approximately \$439,000. Of this amount, approximately \$423,000 was from continuing operations and approximately \$16,000 was from discontinued operations. The cash used for continuing operations was primarily due to the following items:

- Positive cash flow due to a decrease in accounts receivable and cost and earnings in excess of billings on uncompleted contracts of approximately \$848,000,

Table of Contents

- Negative cash flows from a decrease in accounts payable and accrued liabilities of approximately \$129,000,
- Negative cash flows from a decrease in deferred rent of approximately \$273,000 which represents the difference between the rent payment and the rent expense,
- Negative cash flows from a decrease in deferred revenue of approximately \$973,000 due to the timing of billings.

The following non-cash items reflected in the Company's statement of operations are used to reconcile the net loss to the net cash used in operating activities during the six months ended June 30, 2008:

- The Company issued notes in 2004, 2005 and 2006 and preferred stock in 2006, all of which contained embedded derivatives, and associated warrants. In 2008, the Company recognized a loss of approximately \$11,000 related to the increase in value of the derivatives and associated warrants. The increase in value is driven mainly by the increase in value of the underlying BIO-key stock.
- The Company recorded approximately \$369,000 of charges in 2008 for the expense of amortizing intangible assets.
- The Company recorded approximately \$332,000 of charges in 2008 for the expense of issuing options to employees for services.

Net cash provided by investing activities for the six months ended June 30, 2008 was approximately \$98,000, including approximately \$148,000 provided by continuing operations, offset by \$50,000 used by the discontinued Fire business. The cash provided by investing activities for continuing operations was primarily driven by approximately \$153,000 that was released from the escrow account established as part of the in sale of the Fire business. This \$50,000 used for discontinued operations was related to the settlement of a customer claim associated with the discontinued Fire business.

Working capital deficit at June 30, 2008 was approximately \$5,501,000, as compared to a deficit of approximately \$5,796,000 at December 31, 2007, the improvement of which was driven mainly by the reduction of deferred rent as the lease of the Company's Marlborough facility approaches the end of its term.

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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, 2008 our total of cash and cash equivalents was \$624,237 as compared to \$964,774 at December 31, 2007.

As discussed above, the Company has financed itself through access to the capital markets by issuing debt securities, convertible preferred stock and common stock. We currently require approximately \$950,000 per month, to conduct our operations. During the first six months of 2008, we generated approximately \$6,120,000 of revenue and achieved profitability in the three months ended June 30, 2008. While the Company expects to remain profitable through the remainder of 2008, there can be no assurance that we will achieve that goal.

Table of Contents

During the three months ended March 31, 2008, the Company received invoices of approximately \$2,300,000 from a vendor that had been a subcontractor on a long term project for which the Company was the prime contractor. This amount had previously been recorded as an Accrued Liability and has now been moved to Accounts Payable. On July 28, 2008, the Company reached agreement with the vendor to resolve all matters relating to these invoices. Pursuant to this agreement, the parties agreed to a payment schedule under which the Company will be required to satisfy this outstanding balance, plus interest at seven percent (7%) per annum on the unpaid portion of the balance, in full on or before June 1, 2009.

The Company's Series A Convertible Preferred Stock is redeemable in cash by the stockholders within 10 days after December 31, 2008 if certain stock price performance conditions are not met. This date was deferred from March 31, 2008 by an agreement with the holders of the Series A Shares on March 24, 2008.

In addition, the Company's Series B and Series C Convertible Preferred Stock is redeemable in cash by the stockholders during the first quarter of 2009 if certain stock price performance conditions are not met.

Due to several factors, including our history of losses and limited revenue, our former and current independent auditors have included an explanatory paragraph in opinions they have previously issued related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. To the extent that we require such additional financing, no assurance can be given that any form of additional financing will be available on terms acceptable to us, that adequate financing will be obtained to meet our needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or we fail to continue to generate meaningful revenue, we may be required to further reduce operating expenses, delay the expansion of operations, be unable to pursue merger or acquisition candidates, or continue as a going concern.

**ITEM 3. CONTROLS AND PROCEDURES**





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### *Evaluation of 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)) 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, 2008, 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, 2008 as being adequate to provide such assurance.

### *Changes in Internal Control Over Financial Reporting.*

No change in our internal control over financial reporting occurred during the fiscal quarter ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**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.

Table of Contents

**SIGNATURES**



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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 12, 2008

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

Dated: August 12, 2008

/s/ Francis J. Cusick  
Francis J. Cusick  
Chief Financial Officer

Table of Contents

**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.2 (2)           | Employment Agreement, dated June 4, 2008, by and between the Company and Mr. DePasquale                              |
| 31.1(1)            | Certificate of CEO of Registrant required under Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended |
| 31.2 (1)           | Certificate of CFO of Registrant required under Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended |
| 32.1(1)            | Certificate of CEO of Registrant required under 18 U.S.C. Section 1350   |
| 32.2 (1)           | Certificate of CFO of Registrant required under 18 U.S.C. Section 1350   |



- (1) Filed herewith
  
- (2) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on June 5, 2008 and incorporated herein by reference.