

BIO KEY INTERNATIONAL INC

Form 10QSB

May 15, 2007

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

WASHINGTON, D.C. 20549

**FORM 10-QSB**

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

**For the quarterly period ended March 31, 2007**

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

**For the Transition Period from**            **to**

Commission file number 1-13463

**BIO-KEY INTERNATIONAL, INC.**

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10QSB

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



Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10QSB

**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)

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10QSB

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN  
BANKRUPTCY PROCEEDINGS DURING THE  
PRECEDING FIVE YEARS**

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10QSB

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court.

Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate by check mark whether the registrant is a shell company (as defined by rule 12b-2 of the Exchange Act)

Yes  No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: There were 57,483,000 issued and outstanding shares of the registrant's common stock, par value \$.0001 per share, as of May 1, 2007.

Transitional Small Business Disclosure Format (check one): Yes  No

---

**BIO-KEY INTERNATIONAL, INC.**

**INDEX**

PART I. FINANCIAL INFORMATION

<u>Item 1</u>	<u>Condensed Consolidated Financial Statements</u> <u>Balance sheet as of March 31, 2007 (unaudited)</u> <u>Statements of operations for the three months ended March 31, 2007</u> <u>(unaudited) and 2006 (as restated)</u> <u>Statements of cash flows for the three months ended March 31, 2007</u> <u>(unaudited) and 2006 (as restated)</u>
<u>Item 2</u>	<u>Notes to condensed consolidated financial statements</u> <u>Management's Discussion and Analysis of Financial Conditions and</u> <u>Results of Operations</u>
<u>Item 3</u>	<u>Controls and Procedures</u>

PART II. OTHER INFORMATION

<u>Item 3</u>	<u>Defaults Upon Senior Securities</u>
<u>Item 6</u>	<u>Exhibits</u>



**PART I**  
**FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**



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

Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10QSB

	March 31, 2007
<b>ASSETS:</b>	
Cash and cash equivalents	\$ 825,791
Receivables	
Billed, less allowance for doubtful receivables of \$177,750	2,050,627
Unbilled	5,236
Costs and earnings in excess of billings on uncompleted contracts	1,215,045
Inventory	30,262
Prepaid expenses	121,496
Total current assets	4,248,457
Equipment and leasehold improvements, net	373,773
Deposits	757,017
Intangible assets less accumulated amortization	2,304,863
Deferred financing costs, net	114,935
Goodwill	11,389,654
Total non-current assets	14,940,242
<b>TOTAL ASSETS</b>	<b>\$ 19,188,699</b>
<b>LIABILITIES:</b>	
Current maturities of long-term obligations and related obligations, net of discount	\$ 2,975,361
Accounts payable	1,673,863
Billings in excess of costs and earnings on uncompleted contracts	78,343
Accrued liabilities	4,534,657
Deferred rent	515,009
Deferred revenue	4,995,990
Total current liabilities	14,773,223
Warrants and long-term obligations	1,091,098
Redeemable preferred stock derivatives	80,574
Deferred rent	233,412
Deferred revenue	82,755
Total non-current liabilities	1,487,839
<b>TOTAL LIABILITIES</b>	<b>16,261,062</b>
Commitments and contingencies	
Series B redeemable convertible preferred stock: authorized, 1,000,000 shares (liquidation preference of \$1 per share); issued and outstanding 1,000,000 shares of \$.0001 par value respectively, net	816,161
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 respectively, net	5,129,332
	5,945,493
<b>STOCKHOLDERS EQUITY/(DEFICIT):</b>	
Preferred stock authorized, 5,000,000 shares (liquidation preference of \$100 per share) Series A 7% Convertible; issued and outstanding 30,557 shares of \$.0001 par value	3
Common stock authorized, 170,000,000 shares; issued and outstanding; 57,335,363 shares of \$.0001 par value	5,734
Additional paid-in capital	51,731,578
Accumulated deficit	(54,755,171)
<b>TOTAL STOCKHOLDERS EQUITY/(DEFICIT)</b>	<b>(3,017,856)</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY/(DEFICIT)</b>	<b>\$ 19,188,699</b>

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

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

	Three months ended March 31, 2007	2006 (As restated)
<b>Revenues</b>		
Services	\$ 2,595,433	\$ 2,246,911
License fees and other	1,277,063	902,280
	3,872,496	3,149,191
<b>Costs and other expenses</b>		
Cost of services	624,306	673,503
Cost of license fees and other	71,794	81,484
	696,100	754,987
<b>Gross Profit</b>	<b>3,176,396</b>	<b>2,394,204</b>
<b>Operating Expenses</b>		
Selling, general and administrative	2,686,013	2,576,821
Research, development and engineering	1,687,706	1,654,638
	4,373,719	4,231,459
Operating loss	(1,197,323 )	(1,837,255 )
Other income (deductions)		
Derivative and warrant fair value adjustments	829,369	2,444,693
Interest income		
Interest expense	(538,517 )	(2,066,525 )
Loss on extinguishment of debt		(2,322,018 )
Other	(5,902 )	(15,176 )
	284,950	(1,959,026 )
<b>NET LOSS</b>	<b>\$ (912,373 )</b>	<b>\$ (3,796,281 )</b>
<b>Basic and Diluted Loss to Common Shareholders:</b>		
Net loss	\$ (912,373 )	\$ (3,796,281 )
Convertible preferred stock dividends and accretion	(471,390 )	(113,226 )
Net loss attributable to common shareholders	\$ (1,383,763 )	\$ (3,909,507 )
<b>Net Loss Per Share:</b>		
Basic	\$ (0.02 )	\$ (0.08 )
Diluted	\$ (0.02 )	\$ (0.08 )
<b>Weighted Average Shares Outstanding:</b>		
Basic	56,634,523	47,026,773
Diluted	56,634,523	47,026,773

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

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

	Three Months Ended March 31,	
	2007	2006 (As restated)
<b>CASH FLOW FROM OPERATING ACTIVITIES:</b>		
Net Loss	\$ (912,373 )	\$ (3,796,281 )
<b>Adjustments to reconcile net loss to cash used in operating activities:</b>		
Derivative and warrant fair value adjustments	(829,369 )	(2,444,693 )
Loss on extinguishment of debt		2,322,018
Depreciation	71,683	65,044
Amortization		
Intangible assets	215,880	215,880
Deferred financing costs	56,871	91,211
Discounts on convertible debt related to warrants and beneficial conversion features	229,853	895,474
Allowance for doubtful receivables		19,998
Deferred rent	(119,429 )	(105,986 )
Fair market value adjustment on equity issuance	91,182	
Share-based compensation	239,143	120,567
<b>Change in assets and liabilities:</b>		
Accounts receivable trade	1,100,057	(1,504,834 )
Costs and earnings in excess of billings on uncompleted contracts		1,255,102
Inventory	(13,140 )	(1,734 )
Prepaid expenses and other	26,506	(2,705 )
Accounts payable	458,434	318,003
Billings in excess of costs and earnings on uncompleted contracts		10,169
Accrued liabilities	(107,825 )	371,553
Deferred revenue	37,300	1,045,733
Net cash provided (used) in operating activities	544,773	(1,125,481 )
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(16,730 )	(13,720 )
Deposits	43,336	465,657
Patent costs	(9,997 )	(9,983 )
Net cash provided by investing activities	16,609	441,954
<b>CASH FLOW FROM FINANCING ACTIVITIES:</b>		
Issuance of long-term obligations		988,000
Repayment of long term obligations	(362,758 )	(79,859 )
Financing costs		(52,800 )
Net cash (used) provided by financing activities	(362,758 )	855,341
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	198,624	171,814
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	627,167	1,422,827
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$ 825,791	\$ 1,594,641

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

## SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
		<b>(As restated)</b>
<b>Cash paid for:</b>		
Interest	129,651	441,926
<b>Noncash Investing and Financing Activities:</b>		
Conversion of convertible notes and related obligations, net of discount, and accrued interest into common stock	150,000	129,106
Issuance of Series B redeemable preferred stock in exchange for debt and related obligations		988,000
Issuance of common stock in conjunction with refinancing		127,500
Issuance of common stock through conversion of dividends outstanding on Series B and C preferred stock	575,466	
Issuance of common stock in exchange for Series A preferred stock and cumulative dividends in arrears, thereon		125,476
Origination of warrants in conjunction with debt financing		308,376
Origination of embedded derivatives in conjunction with debt financing		679,624
Origination of embedded derivatives with preferred stock		360,467

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



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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

March 31, 2007 (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 ). 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 financial position and the results of its operations and cash flows for the periods presented. 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, 2006 (the Form 10-KSB ).

*Recently Issued Accounting Pronouncements*

In February, 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, 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. Management is currently evaluating the impact and timing of the adoption of SFAS 159 on the Corporation s financial condition and results of operations.

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. As disclosed in the Financial Statements included in the Company s Annual Report on Form 10-KSB for the year ended December 31, 2006, 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 than 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 \$3,765,000. 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 files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company has not been audited by the Internal Revenue Service ( IRS ) or any states in connection with income taxes. The periods from 2000-2006 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. As of the date of adoption of FIN No. 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the quarter.

*Comprehensive Loss*

Comprehensive loss consists of net loss and other gains and losses affecting shareholders equity/(deficit) that, under generally accepted accounting principles, are excluded from net loss in accordance with Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income. The Company, however, does not have any components of other comprehensive loss as defined by SFAS No. 130 and therefore, for the three months ended March 31, 2007 and 2006, comprehensive loss is equivalent to the Company s reported net loss. Accordingly, a separate statement of comprehensive loss is not presented.

*Reclassifications*

Certain amounts in the 2006 consolidated financial statements have been reclassified to conform to the 2007 presentation. These reclassifications had no effect on the previously reported net loss or stockholders equity (deficit).



## 2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

Broad commercial acceptance of the Company's technology is critical to the Company's success and ability to generate revenues. The Company has only recently begun to generate significant revenues, has suffered recurring losses from operations and has a working capital deficit.

The Company is still in need of additional capital however, and is currently considering various alternatives related to raising additional capital including new funding from other sources. 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 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. 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 sheet is dependent upon the Company's ability to obtain additional funding, meet its funding requirements on a continuing basis, and succeed in its future operations. The accompanying financial statements do not include any adjustments that might be necessary should the Company be unable to continue in existence.

## 3. SHARE BASED COMPENSATION

As of January 1, 2006, the Company adopted SFAS 123R using the modified prospective method, 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 net loss by \$239,143, with no effect per share (basic and diluted), for the quarter ended March 31, 2007. There was no impact on cash flows from operating, investing, or financing activities. As the Company uses the full valuation allowance with respect to deferred taxes, SFAS 123R had no impact on deferred taxes.

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

	<b>Three Months Ended March 31, 2007</b>	<b>Three Months Ended March 31, 2006</b>
Cost of services	\$ 8,252	\$ 11,092
Selling, general and administrative	168,266	84,826
Research, development and engineering	62,625	24,649
	<b>\$ 239,143</b>	<b>\$ 120,567</b>



*Valuation Assumptions for Stock Options*

For the three months ended March 31, 2007, 89,000 stock options were granted. The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended			
	March 31, 2007		2006	
Risk free interest rate	4.57	%	4.53-4.73	%
Expected term of options (in years)	4.5		4.0-7.0	
Expected dividends	0	%	0	%
Volatility of stock price	114	%	127	%

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 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 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 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 terminates 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 this 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 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 Plan terminates in October 2014.

*Non-Plan Stock Options*

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

*Stock Option Activity*

The following table summarizes stock option activity for the Three Months ended March 31, 2007:

	Number of Options					Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
	1996 Plan	1999 Plan	2004 Plan	Non Plan	Total			
Outstanding, as of December 31, 2006	125,000	995,000	2,896,419	4,118,000	8,134,419	\$ 0.85	4.64	\$
Granted			89,000		89,000	0.33		
Exercised								
Expired or cancelled	(5,000 )		(132,334 )		(137,334 )	0.76		
<b>Outstanding, as of March 31, 2007</b>	<b>120,000</b>	<b>995,000</b>	<b>2,853,085</b>	<b>4,118,000</b>	<b>8,086,085</b>	<b>0.85</b>	<b>4.40</b>	<b>3,000</b>
<b>Vested or expected to vest at March 31, 2007</b>					<b>7,500,437</b>	<b>0.86</b>	<b>4.27</b>	<b>3,000</b>
<b>Exercisable at March 31, 2007</b>					<b>6,167,703</b>	<b>0.89</b>	<b>3.95</b>	<b>3,000</b>

The options outstanding and exercisable at March 31, 2007 were in the following exercise price ranges:

Range of exercise prices	Options Outstanding			Options Vested		
	Number of shares	Weighted average exercise price	Weighted average remaining life (in years)	Number exercisable	Weighted average exercise price	Weighted average remaining life (in years)
\$0.19	60,000	\$ 0.19	1.40	60,000	\$ 0.19	1.40
.29-.40	984,000	0.33	3.03	815,000	0.33	2.30
.46-.69	2,650,666	0.58	4.31	1,707,955	0.55	3.40
.75-1.11	2,596,919	0.93	5.26	1,956,918	0.97	5.11
1.17-1.62	1,746,500	1.30	4.21	1,579,830	1.30	4.14
6.42	48,000	6.42	0.87	48,000	6.42	0.87
\$0.19-6.42	8,086,085			6,167,703		

The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.24 as of March 31, 2007, 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 March 31, 2007 was 60,000.

The weighted average fair value of options, as determined under SFAS No. 123R, granted during the three months ended March 31, 2007 and March 31, 2006 was \$0.29 and \$0.56 per share, respectively.

The total intrinsic value of options exercised during the three-month period ended March 31, 2007 and March 31, 2006 was \$0 and \$0, respectively.

As of March 31, 2007 future compensation cost related to nonvested stock options is approximately \$619,845 and will be recognized over an estimated weighted average period of approximately 3.0 years.

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

The Company's basic EPS is calculated using net income (loss) and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes the effect from potential issuance of common stock, such as stock issuable pursuant to the exercise of stock options and warrants and the assumed conversion of convertible notes and preferred stock. For the three months ended March 31, 2007, diluted per share computations are not presented since this effect would be antidilutive.

The reconciliation of the numerators and denominators of the basic and diluted EPS calculations was as follows for both of the following three month periods ended March 31:

	<b>Three Months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
		<b>(As restated)</b>
<b>Numerator:</b>		
Net income (loss)	\$ (912,373 )	\$ (3,796,281 )
Convertible preferred stock dividends and accretion	(471,390 )	(113,226 )
Income (loss) available to common stockholders (basic EPS)	(1,383,763 )	(3,909,507 )
Adjustment for interest expense and debt conversion features		
Loss as adjusted (diluted EPS)	\$ (1,383,763 )	\$ (3,909,507 )
<b>Denominator:</b>		
Weighted-average shares used to compute basic EPS	56,634,523	47,026,773
Effect of dilutive securities:		
Convertible notes		
Weighted-average shares used to compute diluted EPS	56,634,523	47,026,773
<b>Earnings (loss) per share</b>		
Basic	\$ (0.02 )	\$ (0.08 )
Diluted	\$ (0.02 )	\$ (0.08 )

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.

	<b>Three Months Ended March 31, 2007</b>	<b>2006</b>
Preferred Stock	19,952,040	5,703,302
Convertible Debt	8,819,771	12,844,568
Stock Options	20,000	841,487
Warrants		25,707
Potentially dilutive securities	28,791,811	19,415,064

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

	<b>Three Months Ended March 31, 2007</b>	<b>2006 (As restated)</b>
Stock options	8,026,085	4,864,741
Warrants	10,566,375	9,982,252
Total	18,592,460	14,846,993

## 5. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements at March 31, 2007 consisted of the following:

	<b>March 31, 2007</b>
Equipment	\$ 581,327
Furniture and fixtures	187,984
Software	118,007
Leasehold improvements	198,889
	1,086,207
Less accumulated depreciation and amortization	(712,434 )
Total	\$ 373,773

## 6. GOODWILL AND OTHER INTANGIBLE ASSETS

The Company's goodwill resulted from the acquisition of Public Safety Group, Inc. and certain assets and assumed liabilities of the Mobile Government Division of Aether Systems, Inc. in 2004. As 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 of each year using a number of criteria, including the value of the overall enterprise. As of March 31, 2007, the Company believes no material impairment exists. Future impairment charges from existing operations or other acquisitions, if any, will be reflected as an operating expense in the statement of operations. As of March 31, 2007 goodwill totaled \$11,389,654.





Other intangible assets as of March 31, 2007 consisted of the following:

	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Copyrighted software	\$ 1,181,429	\$ (708,857 )	\$ 472,572
Customer relationships	1,009,000	(504,500 )	504,500
Trademarks	807,872	(441,918 )	365,954
Developed technology	710,000	(355,000 )	355,000
Marketing agreements	605,340	(363,204 )	242,136
Patents and patents pending	366,219	(1,518 )	364,701
<b>Total</b>	<b>\$ 4,679,860</b>	<b>\$ (2,374,997 )</b>	<b>\$ 2,304,863</b>

Aggregate amortization expense for the three months ended March 31, 2007 and 2006, was \$215,880.

**7. Deferred financing costs**

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

Deferred financing costs are amortized based upon the lives of the respective debt obligations. The gross carrying amount of deferred financing costs at March 31, 2007 was \$295,504, and accumulated amortization was \$180,569. Amortization of deferred financing costs is included in interest expense, and was \$56,871 and \$91,211 for the three months ended March 31, 2007 and 2006 respectively.

### 8. CONVERTIBLE DEBT FINANCING

Long-term obligations consisted of the following as of:

	<b>March 31, 2007</b>
<b>2004</b>	
Convertible term notes	\$ 2,632,533
Discount	(246,138 )
FMV of embedded derivatives	30,528
FMV of warrants	57,020
<b>2005</b>	
Convertible term notes	1,666,667
Discount	(310,580 )
FMV of embedded derivatives	71,983
FMV of warrants	109,432
<b>2006</b>	
FMV of warrants	55,014
	4,066,459
Less current portion	2,975,361
<b>Total</b>	<b>\$ 1,091,098</b>

14

---

*Senior Convertible Term Notes*

**2004 and 2005 Senior Notes**

On September 29, 2004, we entered into a Securities Purchase Agreement (the "2004 Senior Purchase Agreement") with Laurus Master Fund, Ltd. ("Laurus"). Under the 2004 Senior Purchase Agreement, the Company issued secured convertible term notes (the "2004 Senior Note") in the aggregate principal amount of \$5,050,000, convertible into common stock of the Company at an initial conversion price of \$1.35 per share, and issued warrants (the "2004 Senior Warrants") to purchase an aggregate of 1,122,222 shares of our common stock at an initial exercise price of \$1.55 per share. The proceeds from this transaction were used in part to finance the Company's acquisition of Aether Mobile Government.

On June 8, 2005, we entered into a Securities Purchase Agreement (the "2005 Senior Purchase Agreement") with Laurus. Under the 2005 Senior Purchase Agreement, the Company issued a secured convertible term note (the "2005 Senior Note") in the aggregate principal amount of \$2,000,000, convertible into common stock of the Company in certain circumstances at an initial conversion price of \$1.35 per share, and issued a warrant (the "2005 Senior Warrant") to purchase an aggregate of 444,444 shares of our common stock at an initial exercise price of \$1.55 per share. The proceeds from this transaction have been used for the Company's general working capital purposes.

The Company's obligations under the 2004 and 2005 Senior Purchase Agreements, the 2004 and 2005 Senior Notes and the 2004 and 2005 Senior Warrants are secured by a security interest in all or substantially all of the Company's assets.

Under the terms of the 2004 and 2005 Senior Notes, we are required to make monthly payments of accrued interest and principal. The 2004 and 2005 Senior Notes bear interest at an initial rate equal to the prime rate plus two percent (2%), subject to a six percent (6%) floor. The interest rate on the 2005 Senior Note is subject to reduction on a month-by-month basis if the following conditions are met: If (a) we register the common stock underlying the 2004 and 2005 Senior Notes and 2004 and 2005 Senior Warrants on a registration statement declared effective by the Securities and Exchange Commission and (b) our common stock is trading at a 25% or greater premium to the note conversion price, then the interest rate will be adjusted downward by 2.0% for each incremental 25% increase over the note conversion price. Alternatively, if (x) we have not registered such common stock under an effective registration statement, but (y) our common stock is trading at a 25% or greater premium to the note conversion price, then the interest rate will be adjusted downward by 1.0% for each incremental 25% increase over the note conversion price. In no event shall the interest rate be less than 0%.

For cash payments made on the 2004 and 2005 Senior Notes (e.g., any amounts due that are not converted into common stock), we are required to pay an amount equal to 102% of the amount of principal or interest due. In addition, we can prepay the note at any time upon payment of an amount equal to 110% of the then outstanding principal balance, plus accrued and unpaid interest.

Laurus has the option at any time to convert any or all of the outstanding principal and accrued and unpaid interest on the 2004 and 2005 Senior Notes into shares of our common stock at a conversion price of \$0.50 per share, as reduced pursuant to subsequent transactions which are described further below. In addition, for each monthly payment under the note, Laurus will be obligated to convert a portion of the monthly payment into common stock at the applicable conversion price, so long as:

- the average closing price of our common stock (for the five trading days immediately preceding the payment date) is greater than \$0.55 per share (which represents 110% of the note conversion price, based on the conversion price of \$0.50),
- such amount being converted does not exceed 25% of the aggregate dollar trading volume for such immediately preceding twenty-two trading days, and
- the shares of common stock underlying the notes are registered under an effective registration statement with the Securities and Exchange Commission.

The terms of the 2004 and 2005 Senior Notes and 2004 and 2005 Senior Warrants prohibit conversion of the notes or exercise of the warrants to the extent that conversion of the notes and exercise of the warrants would result in any holder thereof, together with its affiliates, beneficially owning in excess of 4.99% of our outstanding shares of common stock. A holder may waive the 4.99% limitation upon 75 days prior written notice to us. Also, this limitation does not preclude the holder from converting or exercising the notes or warrants and selling shares underlying the notes or warrants in stages over time where each stage does not cause the holder and its affiliates to beneficially own shares in excess of the limitation amount.

As security for our obligations to Laurus, we, along with our wholly-owned subsidiary Public Safety Group, Inc. ( PSG ), have granted to Laurus a blanket security interest in all of our assets, and we have entered into a stock pledge with Laurus for the capital stock in PSG. If an event of default occurs under the 2004 or 2005 Senior Notes or the other related investment agreements, 120% of the unpaid principal balance on the 2004 and 2005 Senior Notes, plus accrued interest and fees, shall become immediately due and Laurus shall be entitled to payment of a default interest rate of 1.5% per month on all amounts due under the 2004 and 2005 Senior Notes. Such events of default include the following:

- a failure to pay interest and principal payments under the 2004 or 2005 Senior Notes within three days of when due;
- a breach by us of any material covenant or term or condition of the 2004 or 2005 Senior Notes or in any of the investment agreements, if not cured within 30 days of such breach;
- a breach by us of any material representation or warranty made in the 2004 or 2005 Senior Notes or in any of the investment agreements;
- if we make an assignment for the benefit of our creditors, or a receiver or trustee is appointed for us, or any form of bankruptcy or insolvency proceeding is instituted by us, or any involuntary proceeding is instituted against us if not vacated within 60 days;
- the filing of any money judgment or similar final process against us for more than \$50,000, which remains unvacated, unbonded or unstayed for a period of 30 days;
- if our common stock is suspended for five consecutive days or for five days during any ten consecutive days from a principal market or pursuant to a Securities and Exchange Commission stop order; and
- a failure by us to timely deliver shares of common stock when due upon conversions of the 2004 or 2005 Senior Notes.

Upon an event of default, Laurus will be entitled to specified remedies, including remedies under the Uniform Commercial Code.

Laurus has agreed, pursuant to the Senior Purchase Agreements, that neither it nor any of its affiliates and investment partners will (and will not cause any other person or entity, directly or indirectly, to) engage in short sales of our common stock for as long as any 2004 or 2005 Senior Notes held by it remain outstanding. Short sales are contracts for the sale of shares of stock that the seller does not own, or certificates which are not within the seller's control, so as to be available for delivery at the time when, under applicable rules, delivery must be made.

#### **2004 and 2005 Senior Notes Amendment and Waivers**

Effective as of April 18, 2007, the Company entered into an Amendment and Waiver (the April 2007 Senior Notes Amendment and Waiver ) with Laurus in connection with the 2004 and 2005 Senior Notes then held by Laurus. Under the April 2007 Senior Notes Amendment and Waiver, the 2004 and 2005 Senior Notes issued by the Company to Laurus were amended as follows: (i) the principal amount due and payable under the 2004 and 2005 Senior Notes for the months of March, April and May 2007 is deferred



until the earlier of the Transaction Closing Date or the final maturity dates of the 2004 and 2005 Senior Notes, which are January 1, 2008 and December 1, 2008, respectively. Refer to Note 14.

#### ***2004 and 2005 Senior Note Derivatives***

The 2004 and 2005 Senior Notes (the Notes) contain features that are considered embedded derivative financial instruments: Principal's conversion option: The Notes are convertible at the Holder's option at any time at the fixed conversion price of \$0.50 per share; Monthly Payments Conversion Option: Holders have the option to convert the Notes' monthly payment at a \$0.50 per share conversion price if the common stock price is higher than 110% of the conversion price (\$0.55), as long as the amount converted is not higher than 25% of trading volume for the last 22 trading days. If the Notes' monthly payments are not converted, the payments will be paid in cash at 102% of such amount; Interest Rate Adjustment provision: For every 25% increase in common stock value above \$0.50 per share, the interest will be reduced by 2%. The interest rate may never be reduced below 0%; Default provision: In the event of default under the terms set forth above, the Senior Lenders will be entitled to specified remedies, including remedies under the Uniform Commercial Code. These features have been bifurcated and recorded on the Company's balance sheet at their fair value.

The accounting treatment of the derivatives and warrants requires that the Company record the derivatives and the warrants at their relative fair value as of the inception date of the agreement, and at fair value as of each subsequent balance sheet date. Any change in fair value will be recorded as non-operating, non-cash income or expense at each reporting date. If the fair value of the derivatives and warrants is higher at the subsequent balance sheet date, the Company will record a non-operating, non-cash charge. If the fair value of the derivatives and warrants is lower at the subsequent balance sheet date, the Company will record non-operating, non-cash income.

As of March 31, 2007, the derivatives were valued at \$102,511. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 0%; annual volatility of 61% to 73%; and risk free annual interest rate of 4.7% to 5.0% as well as probability analysis related to trading volume restrictions. The remaining derivatives were valued using other binomial models and measuring the impact of the derivative on the expected interest payment amount over the life of the Note. The Warrants issued with the 2004 and 2005 debt financings classified as liabilities were valued at \$166,452 as of March 31, 2007, using the Black Scholes Option Pricing model with the following assumptions: dividend yield of 0%; annual volatility of 69% to 79% and risk-free interest rate of 4.6%.

The initial relative fair values of both the derivatives and the warrants were recorded as discounts to the Notes and are being amortized to interest expense over the expected term of the debt, using the effective interest method. At March 31, 2007, the unamortized discount on the Notes was \$556,718.

#### **Default on 2004 and 2005 Notes**

With respect to the convertible notes issued in 2004 and 2005, the Company is required to make interest payments or issue registered shares in lieu of interest payments on a monthly basis.

During the period ended March 31, 2007, the Company made the required payments to the 2004 and 2005 senior debt holder, Laurus, for all months except for March 2007. However, as Laurus had agreed to defer the March 2007 principal payment on the 2004 and 2005 Notes, it was not regarded by the Company or Laurus as a default. Refer to Note 14 for information on the full Amendment and Waiver agreement.

Due to the previous defaults on Senior and Subordinated Notes held by the Company, obligations totaling \$622,764 were accrued in prior periods, the balance of which was unchanged as at March 31, 2007. Effective December 29, 2006, the Company entered into an agreement with Laurus, to convert the default interest payable by the Company to Laurus of \$622,764 into 1,000,000 shares of common stock. This

agreement was made subject to the Company raising at least \$2,000,000 in gross proceeds from the issuance of new equity securities before March 29, 2007. As the Company did not raise at least \$2,000,000 in gross proceeds from the issuance of new equity securities before March 29, 2007, the default interest remained as a liability as March 31, 2007.

Effective April 18, 2007, the Company entered into an agreement with Laurus, to convert the default interest payable by the Company to Laurus of \$622,764 into 850,000 shares of restricted common stock. This agreement was made on the assumption the Company will consummate a business transaction on or before May 18, 2007, or such later date as the parties may agree, which will raise sufficient proceeds to repay all of the Company's obligations under the 2004 and 2005 Notes. Refer to Note 14.

Total accrued interest for all convertible debt as for March 31, 2007 amounted to \$661,590.

## 9. ACCRUED LIABILITIES

Accrued liabilities at March 31, 2007 consisted of the following:

	<b>March 31, 2007</b>
Contract costs not yet invoiced by vendors	\$ 2,132,807
Compensation	663,026
Royalties	255,331
Interest	1,012,530
Other	470,963
<b>Total</b>	<b>\$ 4,534,657</b>

## 10. REDEEMABLE PREFERRED STOCK

### Series B Convertible Preferred Stock

The Company issued 1,000,000 shares of redeemable Series B Convertible Preferred Stock on February 23, 2006, upon the conversion of certain convertible term notes. Each share of Series B preferred stock has an Original Issue Price of \$1.00 per share. The holder has the option to redeem the shares of Series B preferred stock at any time for a number of shares of the Company's common stock equal to the Original Issue Price plus accumulated and unpaid dividends divided by the fixed conversion price of \$0.50 per share of Common Stock. The conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series B preferred stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price less than the conversion price. Mandatory conversion of all Series B shares will be automatic if, for the 30 trading days prior to January 1, 2009, the average closing bid price for one share of common stock is at least \$1.10. The shares shall be converted at the conversion price then in effect. If the average bid price for the 30 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 commencing April 1, 2006. 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 March 31, 2007, 1,000,000 preferred stock shares were authorized, issued and outstanding, at a par value of \$0.0001 and a liquidation preference of \$1.00 with accumulated dividends in arrears of \$37,500, 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 \$0.50 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 March 31, 2007 the derivatives were valued at \$11,734. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 15%; annual volatility of 35%; and risk free annual interest rate of 4.58% 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 March 31, 2007, the unamortized discount on the Preferred Stock was \$221,339.

### **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 \$0.50 per share of Common Stock. The conversion price is subject to adjustment if common stock is issued by the Company subsequent to the original issue date of the Series C preferred stock, except for other conversions, options, warrants, dividends paid in stock or pursuant to an acquisition by the Company, at a price less than the conversion price. Mandatory conversion of all Series C shares will be automatic if, for the 30 trading days prior to January 1, 2009, the average closing bid price for one share of common stock is at least \$1.20. The shares shall be converted at the conversion price then in effect. If the average bid price for the 30 trading days prior to January 1, 2009 per common share is less than \$1.20 the Company shall mandatorily redeem all remaining outstanding Series C preferred stock by paying cash equal to \$10.00 per share with all accrued and unpaid dividends. The Company may, at its election, redeem any or all of the remaining outstanding Series C shares in cash at a conversion price equal to \$12.00 per share, together with all accrued and unpaid dividends upon giving 30 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 commencing September 1, 2006. 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 March 31, 2007, 600,000 preferred stock shares 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 \$76,473, 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 \$0.50 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 March 31, 2007 the derivatives were valued at \$68,840. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 15%; annual volatility of 35%; and risk free annual interest rate of 4.58% 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 term of the Preferred Stock. At March 31, 2007, the unamortized discount on the Preferred Stock was \$786,528.

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 Preferred Stock. At March 31, 2007, the net amount remaining to be accreted was \$80,932.

## 11. STOCKHOLDERS EQUITY

### Common Stock

The Company is authorized to issue 170,000,000 shares of common stock, \$0.0001 par value per share, of which 57,335,363 were outstanding as of March 31, 2007.

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

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

During the three months ended March 31, 2007, pursuant to an Amendment and Waiver with Laurus consummated on December 29, 2006, Laurus converted \$150,000 in principal on its convertible term notes into 568,182 shares of the Company's common stock. The Company recorded a non-cash interest expense of approximately \$91,000, which represented the value of additional common shares issued to Laurus as consideration for exchanging convertible debt for equity instead of paying the outstanding principal payment in cash.

During the three months ended March 31, 2007, the holders of Series B and Series C Preferred Stock converted accumulated dividends of \$575,466 into 1,608,367 shares of the Company's common stock.

### Series A Convertible Preferred Stock

Within the limits and restrictions provided in the Company's Certificate of Incorporation, the Board of Directors has the authority, without further action by the shareholders, to issue up to 5,000,000 shares of preferred stock, \$.0001 par value per share, in one or more series, and to fix, as to any such series, any 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 March 31, 2007. The following describes the material provisions of the Series A Shares which are more fully set forth in the Certificate of Designation on file with the Delaware Secretary of State.

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 \$0.50 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 March 3, 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. This date was deferred from March 3, 2007 to March 3, 2008 by an agreement with the holders of the Series A Shares on March 28, 2007.

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

As of March 31, 2007, cumulative dividends in arrears related to the Series A preferred stock were approximately \$80,558, which have been accreted to the principal balance of the Series A preferred stock.

Warrants

The following table summarizes the warrant activity for the three month period ending March 31, 2007:

<b>Balance, December 31, 2006</b>	10,566,375
Granted	
Exchanged	
Exercised	
Expired or cancelled	
<b>Balance, March 31, 2007</b>	10,566,375

12. SEGMENT INFORMATION

The Company's consolidated operations are divided into three segments: Law, Fire 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 segments 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.

Geographically North American sales accounted for approximately 100% of the Company's total sales for the three month periods ended March 31, 2007 and 2006.

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

	<b>Three Months Ended March 31, 2007</b>	<b>2006 (As Restated)</b>
<b>Revenue:</b>		
Law	\$ 2,597,672	\$ 2,024,625
Fire	1,157,256	705,132
Biometrics	117,568	419,434
Consolidated Revenue	\$ 3,872,496	\$ 3,149,191
<b>Segment operating profit/(loss)</b>		
Law	(110,214 )	(730,314 )
Fire	(337,604 )	(584,404 )
Biometrics	(749,505 )	(522,537 )
Total Segment Operating Loss	(1,197,323 )	(1,837,255 )
<b>Reconciliation to net loss</b>		
Interest expense	(538,517 )	(2,066,525 )
Interest income		
Loss on extinguishment of debt		(2,322,018 )
Derivative and warrant fair value adjustments	829,369	2,444,693
Other expense	(5,902 )	(15,176 )
<b>Net loss</b>	<b>\$ (912,373 )</b>	<b>\$ (3,796,281 )</b>

### 13. EXTINGUISHMENT OF DEBT

To address certain liquidity issues, on January 23, 2006, the Company issued convertible debt, common stock and warrants in consideration for certain modifications of its outstanding 2004 and 2005 Notes, as explained in Note 8.

In addition, the Company also entered into a Securities Purchase Agreement (the "Securities Purchase Agreement"), effective as of January 23, 2006, with The Shaar Fund, Ltd., Longview Fund, L.P. and Longview Special Finance (collectively, the "Purchasers"), also as explained in Note 8.

In accordance with the Emerging Issues Task Force of the FASB No. 96-19, Debtor's Accounting for Modification or Exchange of Debt Terms (EITF 96-19), the Company treated the above transaction as an extinguishment of debt, and recorded a non-operating loss on extinguishment of debt of \$2,322,018 for the January 2006 transaction.

### 14. SUBSEQUENT EVENTS

Effective as of April 18, 2007, the Company entered into an Amendment and Waiver (the "April 2007 Senior Notes Amendment and Waiver") with Laurus in connection with the 2004 and 2005 Senior Notes then held by Laurus.

22

Under the April 2007 Secured Notes Amendment and Waiver, the Secured Notes issued by the Company to Laurus on September 29, 2004 in the aggregate original principal amount of \$5,000,000 (the 2004 Senior Note ) and on June 8, 2005 in the aggregate original principal amount of \$2,000,000 (the 2005 Senior Note ) were amended as follows: (i) the principal amount due and payable under the 2004 and 2005 Senior Notes for the months of March, April and May 2007 is deferred until the earlier of the closing of a qualified financing transaction, or the final maturity dates of the 2004 and 2005 Senior Notes, which are January 1, 2008 and December 1, 2008, respectively ( the Principal Deferral ).

In addition, under the April 2007 Secured Notes Amendment and Waiver, the Company agreed to issue 850,000 shares of restricted common stock to Laurus as consideration for: (i) the foregoing Principal Deferral; (ii) the full satisfaction of all of the Company's default obligations to Laurus, which amount to \$622,764, that have been incurred by the Company as a result of any Event of Default by the Company under the 2004 and 2005 Senior and Subordinated Note agreements; and (iii) the waiver of all prepayment fees and penalties arising from the Company prepaying the obligations under the Notes under certain circumstances.

The April 2007 Secured Notes Amendment and Waiver agreement was entered into on the assumption the Company will consummate a business transaction on or before May 18, 2007, which will raise sufficient proceeds to repay all of the Company's obligations under the 2004 and 2005 Notes. Failure to (i) consummate such a transaction on or before May 18, 2007, or such later date as the parties may agree in writing, and (ii) apply the transaction proceeds to the repayment in full of the Senior Notes obligations shall constitute an Event of Default under the 2004 and 2005 Senior Notes.

23

---

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

**CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS**

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

The information contained in this Report on Form 10-QSB 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-QSB, 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**

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

We develop and market proprietary fingerprint identification biometric technology and software solutions. We also deliver advanced identification solutions and information services to law enforcement departments, public safety agencies and other government and private sector customers. Our mobile wireless technology provides first responders with critical, reliable, real-time data and images from local, state and national databases.

We pioneered the development of automated, finger identification technology that can be used without the aid of non-automated methods of identification such as a personal identification, password, token, smart card, ID card, credit card, passport, driver's license or other form of possession or knowledge based identification. This advanced BIO-key identification technology improves both the accuracy and speed of finger-based biometrics and is the only finger identification algorithm that has been certified by the International Computer Security Association (ICSA).

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

On March 30, 2004, we acquired all of the outstanding capital stock of Public Safety Group, Inc., a privately-held provider of wireless solutions for law enforcement and public safety markets based in Winter Park, Florida, in exchange for an aggregate of 2,422,108 shares of our common stock, \$500,000 in cash, and our assumption of \$600,000 in aggregate net liabilities of PSG. The acquisition was completed pursuant to the terms of an agreement and plan of merger by and among the Company, BIO-key Acquisition Corp., a wholly-owned subsidiary of the Company, PSG and all of the shareholders of PSG. As a result of this transaction, PSG became a wholly-owned subsidiary of the Company.

On September 30, 2004, we completed our acquisition of the Mobile Government Division from Aether Systems Inc. Pursuant to the Asset Purchase Agreement dated as of August 16, 2004 by and among the



Company, Aether, Cerulean Technology, Inc. and SunPro, Inc., the Company paid Aether a purchase price of \$10,000,000 in cash, subject to post-closing adjustments to reflect changes in Aether Mobile Government's working capital and cash flows since June 30, 2004. Post-closing working capital adjustments resulted in an additional payment by the Company of \$341,878 in December 2004.

The Mobile Government Division provides wireless data solutions for use by public safety organizations, primarily state and local police, fire and rescue and emergency medical services organizations that enable such organizations to access law enforcement databases to validate identities and obtain suspect information. Its public safety solutions are integrated into fifty (50) different state databases, as well as local and federal databases, and its products deliver real-time information in seconds, without the need for human dispatchers or other resources.

### **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, 2006. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-KSB filed on March 30, 2007.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

In February, 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, 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. Management is currently evaluating the impact and timing of the adoption of SFAS 159 on the Corporation's financial condition and results of operations.

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 was effective for the Company's interim period beginning January 1 2007. The implementation of FIN 48 did not have a material impact on the Company's financial statements.

**RESULTS OF OPERATIONS**

**THREE MONTHS ENDED MARCH 31, 2007**

**AS COMPARED TO MARCH 31, 2006**

**INTRODUCTION**

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

The Company operates under three business segments: Biometrics, Law Enforcement and Fire Safety. Each segment is headed by a General Manager and organized to quickly respond to market needs as well as to drive down costs to achieve profitability. Management believes that this initiative will lead to increased opportunities throughout 2007 as the General Managers continue to develop their business units. During the quarter ended March 31, 2007 the Company continued to stay focused on its objectives of increasing revenue and managing expenses.

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

	<b>Three Months Ended March 31,</b>			
	<b>2007</b>		<b>2006</b>	
			<b>(As restated)</b>	
<b>Revenues</b>				
Services	67	%	71	%
License fees and other	33	%	29	%
	100	%	100	%
<b>Costs and other expenses</b>				
Services	15	%	21	%
Cost of license fees and other	2	%	3	%
Selling, general and administrative	70	%	82	%
Research, development and engineering	44	%	53	%
	131	%	159	%
<b>Operating loss</b>	<b>-31</b>	<b>%</b>	<b>-59</b>	<b>%</b>
<b>Other income (deductions)</b>				
Total other income (deductions)	7	%	-62	%
<b>NET LOSS</b>	<b>-24</b>	<b>%</b>	<b>-121</b>	<b>%</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.

	Three months ended March 31,				
	2007	2006	\$ Change	% Change	
<i>Revenues</i>					
<b>Law Enforcement</b>					
Service	\$ 1,853,334	\$ 1,598,559	\$ 254,775	16	%
License & other	744,338	426,066	318,272	75	%
	2,597,672	2,024,625	573,047	28	%
<b>Fire Safety</b>					
Service	720,257	631,732	88,525	14	%
License & other	436,999	73,400	363,599	495	%
	1,157,256	705,132	452,124	64	%
<b>Biometrics</b>					
Service	21,842	16,618	5,224	31	%
License & other	95,726	402,816	(307,090)	-76	%
	117,568	419,434	(301,866)	-72	%
<b>Total Revenue</b>	<b>\$ 3,872,496</b>	<b>\$ 3,149,191</b>	<b>\$ 723,305</b>	<b>23</b>	<b>%</b>
<i>Cost of goods sold</i>					
<b>Law Enforcement</b>					
Service	\$ 353,958	\$ 424,929	\$ (70,971)	-17	%
License & other	18,635	33,087	(14,452)	-44	%
	372,593	458,016	(85,423)	-19	%
<b>Fire Safety</b>					
Service	244,097	217,415	26,682	12	%
License & other	40,884	37,560	3,324	9	%
	284,981	254,975	30,006	12	%
<b>Biometrics</b>					
Service	26,251	31,159	(4,908)	-16	%
License & other	12,275	10,837	1,438	13	%
	38,526	41,996	(3,470)	-8	%
<b>Total COGS</b>	<b>\$ 696,100</b>	<b>\$ 754,987</b>	<b>\$ (58,887)</b>	<b>-8</b>	<b>%</b>

Revenues*Law Enforcement*

License revenue in this segment increased by 75% over the same period in 2006 and included a \$244,000 sale to a new customer. Service revenue for the segment for the three month period ended March 31, 2007 included \$293,000 from a long-term project that the Company had participated in as a subcontractor.

*Fire Safety*

For the three months ended March 31, 2007, total revenue for the Fire Safety segment increased by 64%, over the same three months in 2006. The current year license revenue included \$265,000 in license sales as part of a county wide solution being implemented by the Company.

*Biometrics*

For the three months ended March 31, 2007, the Biometric segment had a decline in revenues over the same period in 2006, as the 2006 results included a substantial license sale to a single customer. Sales in this segment continue to be unpredictable as the market for the Biometrics products continues to develop at an inconsistent pace.

*Costs of goods sold*Law Enforcement

License and other costs are attributable primarily to revenues derived from product sales for which we are required to pay a royalty and is primarily driven by the sales mix.

Cost of Services declined as compared to the same period in 2006 and as a percentage of service revenue due to the continued focus to move from long-term projects to licensing-based agreements.

Fire Safety

License and other costs are attributable primarily to revenues derived from product sales for which we are required to pay a royalty. These costs are solely dependent specifically on what products were sold.

Service costs of goods sold for the Fire segment were higher in 2007 primarily due to the addition of a dedicated headcount resource to support the growing installed base of the segment.

Biometrics

License and other costs are primarily related to the hardware costs attributable to sales of biometric fingerprint readers. The change in cost of goods sold is directly attributable to the product mix between types of readers sold and the volume of readers sold, as well as the addition of dedicated personnel for this segment.

Selling, general and administrative

	Three months ended March 31, 2007	2006	\$ Change	% Change
<b>Law Enforcement</b>	\$ 1,306,121	\$ 1,354,772	\$ (48,651 )	-4 %
<b>Fire Safety</b>	848,643	700,390	148,253	21 %
<b>Biometrics</b>	531,249	521,659	9,590	2 %
<b>Total</b>	\$ 2,686,013	\$ 2,576,821	\$ 109,192	4 %

As discussed previously, the Company restructured its operations into three business segments: Biometrics, Law Enforcement and Fire Safety in the fourth quarter of 2005. For 2006, SG&A costs were allocated to the segments based on several factors including management's estimates and percentage of revenue. For 2007, sales commission expenses are a direct cost to the segment and G&A costs are allocated between business segments on fixed percentages that were established by management during the budgeting process.

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

The overall increase in total SG&A costs for the quarter ended March 31, 2007 as compared to 2006 are primarily due to \$426,000 in legal and regulatory costs associated with the failed acquisition of a Canadian company. That increase was offset by lower accounting and consulting fees that were included in 2006 relating to reporting and compliance issues that the Company experienced due to the restatements and amendments of our previously filed financial and registration statements.

### Research, development and engineering

	Three months ended March 31, 2007	2006	\$ Change	% Change	
<b>Law Enforcement</b>	\$ 1,029,172	\$ 942,150	\$ 87,022	9	%
<b>Fire Safety</b>	361,236	334,173	27,063	8	%
<b>Biometrics</b>	297,298	378,315	(81,017)	)	-21
<b>Total</b>	\$ 1,687,706	\$ 1,654,638	\$ 33,068	2	%

### Law Enforcement and Fire Safety

The increase in R& D costs for the three months ended March 31, 2007 over the same period in 2006 is primarily due to increased salary and benefit costs.

### Biometrics

R & D costs have decreased in the first quarter of 2007 as compared to 2006 primarily as a result of lower staff costs due to attrition. Management believes the current level of engineering headcount is appropriate to support the Bio-Metric product and its installed customer base.

### Other income and expense

	Three months ended March 31, 2007	2006	\$ Change	% Change	
<b>Interest expense</b>	\$ (538,517 )	\$ (2,066,524 )	\$ 1,528,008	-74	%
<b>Derivative and warrant fair value adjustments</b>	829,369	2,444,693	(1,615,324 )	-66	%
<b>Loss on extinguishment of debt</b>		(2,322,018 )	2,322,018	-100	%
<b>Other income (expense)</b>	(5,902 )	(15,177 )	9,274	-61	%
<b>Total</b>	\$ 284,950	\$ (1,959,026 )	\$ 2,243,976	-115	%

For the quarter ended March 31, 2007, consolidated interest expense reduced \$1,528,008 or 74% as compared to the same quarter in 2006. The change was attributable to a decrease in long term debt due to the Company refinancing which occurred in August 2006, and the expiration of the letter of credit arrangement with Aether Systems Inc. on December 31, 2006. Interest expense includes actual cash paid for interest as well as non-cash charges for amortization of debt discounts and deferred charges.

For the quarter ended March 31, 2007, derivative and warrant fair value adjustments decreased, when compared to the 2006 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 debt at different points in time.

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 January 2006 debt restructuring. 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 March 31, 2007.

## LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operations during the three months ended March 31, 2007 was approximately \$545,000 compared to approximately \$1,125,500 used during the three months ended March 31, 2006. Some of the major drivers of this change are discussed in more detail below.

- The Company reported positive cash flows related to a decrease in receivables of approximately \$1,100,000 in the three months ended March 31, 2007, relating to increase collections from yearly maintenance billings and a general growth in license and service revenues for the period.
- Positive cash flows were reported from an increase in accounts payable of approximately \$458,000 due to an increased emphasis on cash flow management. The increase in the accounts payable balance was offset by a decrease in accrued liabilities of approximately \$108,000.

The following non-cash items that are 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 three months ended March 31, 2007:

- The Company issued notes in 2004, 2005 and 2006 that contained embedded derivatives and warrants. In the three months ended March 31, 2007, the Company recorded a gain of approximately \$829,000 related to the decrease in value of these instruments. The decrease in value was predominately caused by the decline in the value of the underlying BIO-key stock.
- A debt discount was recorded when the notes were initially recorded to reflect the fair market value of derivatives and warrants related to the debt. The discount is amortized using the effective interest method into earnings over the life of the related debt. In the three months ended March 31, 2007, the Company recorded non-cash interest expense related to the amortization of the debt discount of approximately \$230,000.
- The company recorded approximately \$216,000 of charges in 2007 and 2006, respectively, for the non-cash expense of amortizing intangible assets.
- The Company recorded a non-cash interest expense of approximately \$91,000 when issuing common stock to Laurus in January 2007. The charge represented the value of additional common shares issued to Laurus as consideration for exchanging convertible debt for equity instead of paying the outstanding principal payment in cash.
- The Company recorded approximately \$239,000 and \$121,000 of charges in 2007 and 2006, respectively, for the share-based compensation expense of issuing options employees for services.



Net cash provided by investing activities for the three months ended March 31, 2007 was approximately \$17,000, largely a result of the return of \$43,000 of deposits related to long-term contracts. This compares to net cash provided by investing activities of approximately \$442,000 for the corresponding period in 2006. The 2006 amount consisted of approximately \$466,000 from the return of deposits related to long-term contracts.

Net cash used by financing activities during the three months ended March 31, 2007 was approximately \$363,000 compared to net cash provided by financing activities of approximately \$855,000 in the corresponding period in 2006. The 2007 amount included debt repayments of \$363,000, while the 2006 amount included debt proceeds of approximately \$988,000, offset by debt repayments of approximately \$80,000.

Working capital deficit at March 31, 2007 was approximately \$10,525,000 as compared to a deficit of approximately \$8,648,000 at December 31, 2006, the deterioration of which was driven mainly by the collection of outstanding receivables, and increase in short-term debt (decrease of long-term debt), and payables during the three months ended March 31, 2007.

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

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

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

#### *Liquidity outlook*

At March 31, 2007 our total of cash and cash equivalents was \$825,791 as compared to \$627,167 at December 31, 2006. 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 \$1,700,000 per month, excluding debt related payments, to conduct our operations. During the first three months of 2007, we generated approximately \$3,872,000 of revenue and expect to increase quarterly revenue during the remainder of 2007, and into 2008. During the first quarter of 2007, the Company incurred approximately \$400,000 in legal and accounting fees with respect to the unsuccessful takeover bid for a Canadian organization. The amount is expected to be paid over the first six months of 2007.

During 2006, the Company incurred significant expenses in order to complete several SB-2 registration statements related to various financing transactions, and to restate prior year financial statements. While the Company does not expect these costs to continue into 2007, there will be additional costs incurred in order for the Company to comply with Section 404 of the Sarbanes-Oxley Act of 2002.

The Company's Series A Convertible Preferred Stock may be redeemable in cash by the stockholders during the second quarter of 2008, if certain stock price performance conditions are not met. This date was deferred from March 3, 2007 to March 3, 2008 by an agreement with the holders of the Series A shares on March 28, 2007.

On April 18, 2007, the Company entered into an agreement with Laurus to defer the March, April and May 2007 principal payments in its Senior Notes. The Company also agreed to issue 850,000 shares of restricted common stock as consideration for: (i) the Principal Deferral; (ii) full satisfaction of the \$622,764 of default obligations owing to Laurus; and (iii) the waiver of all prepayment fees and penalties arising from the Company prepaying the obligations under the Notes. This agreement was entered into on the assumption

the Company will consummate a business transaction on or before May 18, 2007, or such later date as the parties may agree, which will raise sufficient proceeds to repay all of the Company's obligations under the 2004 and 2005 Senior Notes.

We need to obtain additional funding to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we need to obtain additional financing through the issuance of debt or equity securities, or to restructure our financial position through similar transactions to those consummated during 2006.

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 unavailable 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**

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

### *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 quarter ended March 31, 2007, our CEO and CFO determined that, as of that date, 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-QSB for the quarterly period ended March 31, 2007 as being adequate to provide such assurance.

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

No change in our internal control over financial reporting occurred during the fiscal quarter ended March 31, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Effective internal control over financial reporting and disclosure controls and procedures are necessary for us to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. We have in the past discovered, and may in the future discover, areas of our disclosure and internal controls that need improvement. As of March 31, 2007, we believe we have addressed these issues, ensuring that our internal control over financial reporting and disclosure controls and procedures have

improved sufficiently for us provide reasonable assurance that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. If, however, we cannot provide reliable financial reports or prevent fraud, our reputation and operating results would be harmed.

We cannot be certain that our efforts to remediate previous material weaknesses in our internal control over financial reporting and the ineffectiveness of our disclosure controls and procedures will continue to be successful or that we will be able to maintain adequate controls over our financial processes and reporting in the future. We have committed substantial resources, including substantial time from our management team's accounting personnel and from external consultants, to implement and integrate into our organization improved disclosure controls and additional procedures generally and to improve systems to report financial information on a timely basis.

Any failure to maintain effective controls, or difficulties encountered in their implementation or in other effective improvement of our internal and disclosure controls could materially harm our operating results or cause us to fail to meet our reporting obligations. If we are unable to adequately establish or improve our internal controls over financial reporting, or if we maintain an ineffective system of disclosure controls and procedures, our financial statements may not accurately reflect the financial condition of the Company, and current and potential future investors may not be able to rely upon our financial statements. Additionally, our external auditors may not be able to issue an unqualified opinion on the effectiveness of our internal controls. Ineffective internal and disclosure controls could also cause investors to lose confidence in our reported financial information, which would likely have a significant negative effect on the trading price of our securities.

Moreover, because of the inherent limitations in all control systems, no evaluation of controls, even where we conclude the controls are operating effectively, can provide absolute assurance that all control issues, including instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, our control systems, as we develop them, may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected and could be material to our financial statements.

The certifications of our principal executive officer and principal financial officer required in accordance with Rule 13a-14(a) under the Exchange Act and Section 302 of the Sarbanes-Oxley Act of 2002 are attached as exhibits to this Quarterly Report on Form 10-QSB. The disclosures set forth in this Item 3 contain information concerning the evaluation of our disclosure controls and procedures, and changes in internal control over financial reporting, referred to in paragraph 4 of the certifications. Those certifications should be read in conjunction with this Item 3 for a more complete understanding of the matters covered by the certifications.

## **PART II OTHER INFORMATION**

*ITEM 3. DEFAULTS UPON SENIOR SECURITIES*

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

With respect to the convertible notes issued in 2004 and 2005, the Company is required to make principal and interest payments or issue registered shares in lieu of principal and interest payments on a monthly basis.

33

---

During the period ended March 31, 2007, the Company made the required payments to the 2004 and 2005 senior debt holder, Laurus, for all months except for March 2007. However, as Laurus had agreed to defer the March 2007 principal payment on the 2004 and 2005 Notes, it was not regarded by the Company or Laurus as a default. Refer to Note 14 for information on the full Amendment and Waiver agreement.

Due to the previous defaults on Senior and Subordinated Notes held by the Company, obligations totaling \$622,764 were accrued in prior periods, the balance of which was unchanged as at March 31, 2007. Effective December 29, 2006, the Company entered into an agreement with Laurus, to convert the default interest payable by the Company to Laurus of \$622,764 into 1,000,000 shares of common stock. This agreement was made subject to the Company raising at least \$2,000,000 in gross proceeds from the issuance of new equity securities before March 29, 2007. As the Company did not raise at least \$2,000,000 in gross proceeds from the issuance of new equity securities before March 29, 2007, the default interest remained as a liability as March 31, 2007.

Effective April 18, 2007, the Company entered into an agreement with Laurus, to convert the default interest payable by the Company to Laurus of \$622,764 into 850,000 shares of restricted common stock. This agreement was made on the assumption the Company will consummate a business transaction on or before May 18, 2007, or such later date as the parties may agree, which will raise sufficient proceeds to repay all of the Company's obligations under the 2004 and 2005 Notes. Refer to Note 14.

Total accrued interest for all convertible debt as for March 31, 2007 amounted to \$661,590.

#### **ITEM 6. EXHIBITS**

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

34

---

**SIGNATURES**



Edgar Filing: BIO KEY INTERNATIONAL INC - Form 10QSB

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

**BIO-Key International, Inc.**

Dated: May 15, 2007

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

Dated: May 15, 2007

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

35

---

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
10.1 (2)	Amendment and Waiver, dated as of April 18, 2007, by and between the Company and Laurus Master Fund, Ltd.
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 April 24, 2007 and incorporated herein by reference.

36

---