

BIO KEY INTERNATIONAL INC  
Form 10-Q  
November 14, 2011

U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

or

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

For the Transition Period from to

Commission file number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE 41-1741861

(State or Other Jurisdiction (IRS Employer  
of Identification Number)

Incorporation of  
Organization)

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

(Address of Principal Executive Offices)

(732) 359-1100

(Issuer's Telephone Number)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer  Non-accelerated  
filer  Smaller Reporting Company

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

Number of shares of Common Stock, \$.0001 par value per share, outstanding as of November 11, 2011 was 78,155,413.

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BIO-KEY INTERNATIONAL, INC.

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## PART I -- FINANCIAL INFORMATION

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

|  | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and cash equivalents  | \$ 193,518                           | \$ 1,010,096         |
| Accounts receivable, net of allowance for doubtful accounts of \$11,526 at September 30, 2011 and December 31, 2010                                | 1,013,954                            | 351,093              |
| Note receivable , current portion  | -                                    | 2,167,000            |
| Inventory  | 20,253                               | 9,775                |
| Prepaid expenses and other   | 110,170                              | 188,916              |
| Total current assets   | 1,337,895                            | 3,726,880            |
| Equipment and leasehold improvements, net  | 61,366                               | 28,128               |
| Deposits and other assets  | 8,712                                | 8,712                |
| Note receivable, net of current portion  | -                                    | 1,333,000            |
| Intangible assets—less accumulated amortization  | 209,998                              | 218,450              |
| Total non-current assets   | 280,076                              | 1,588,290            |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,617,971</b>                  | <b>\$ 5,315,170</b>  |
| <b>LIABILITIES</b>   |                                      |                      |
| Accounts payable   | \$ 403,713                           | \$ 180,413           |
| Accrued liabilities  | 561,917                              | 1,079,117            |
| Deferred revenue   | 578,990                              | 281,393              |
| Current portion of notes payable   | -                                    | 2,098,139            |
| Total current liabilities  | 1,544,620                            | 3,639,062            |
| Long term portion of notes payable   | 346,428                              | 1,102,492            |
| Deferred revenue   | 2,640                                | 4,281                |
| Total non-current liabilities  | 349,068                              | 1,106,773            |
| <b>TOTAL LIABILITIES</b>   | <b>1,893,688</b>                     | <b>4,745,835</b>     |
| Commitments and contingencies  |                                      |                      |
| <b>STOCKHOLDERS' (DEFICIENCY) EQUITY:</b>  |                                      |                      |
| Common stock — authorized, 170,000,000 shares; issued and outstanding; 78,155,413 of \$.0001 par value at September 30, 2011 and December 31, 2010 | 7,815                                | 7,815                |
| Additional paid-in capital   | 51,004,871                           | 50,955,602           |
| Accumulated deficit  | (51,288,403 )                        | (50,394,082 )        |
| <b>TOTAL STOCKHOLDERS' (DEFICIENCY) EQUITY</b>   | <b>(275,717 )</b>                    | <b>569,335</b>       |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' (DEFICIENCY) EQUITY</b>   | <b>\$ 1,617,971</b>                  | <b>\$ 5,315,170</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<br>September 30, |               | Nine months ended<br>September 30, |            |
|--|-------------------------------------|---------------|------------------------------------|------------|
|  | 2011                                | 2010          | 2011                               | 2010       |
| <b>Revenues</b>  |                                     |               |                                    |            |
| Services   | \$ 229,422                          | \$ 112,090    | \$ 538,394                         | \$ 316,478 |
| License fees and other   | 344,666                             | 434,286       | 2,424,959                          | 2,639,124  |
|  | 574,088                             | 546,376       | 2,963,353                          | 2,955,602  |
| <b>Costs and other expenses</b>                                  |                                     |               |                                    |            |
| Cost of services   | 42,719                              | 30,203        | 108,534                            | 80,391     |
| Cost of license fees and other                                   | 168,167                             | 175,967       | 509,799                            | 339,720    |
|  | 210,886                             | 206,170       | 618,333                            | 420,111    |
| Gross Profit   | 363,202                             | 340,206       | 2,345,020                          | 2,535,491  |
| <b>Operating Expenses</b>  |                                     |               |                                    |            |
| Selling, general and administrative                              | 626,589                             | 817,348       | 1,974,552                          | 2,414,810  |
| Research, development and engineering                            | 270,583                             | 265,682       | 854,489                            | 825,607    |
|  | 897,172                             | 1,083,030     | 2,829,041                          | 3,240,417  |
| Operating loss   | (533,970 )                          | (742,824 )    | (484,021 )                         | (704,926 ) |
| <b>Other income (expenses)</b>                                   |                                     |               |                                    |            |
| Interest income  | 2                                   | 61,343        | 95,031                             | 182,295    |
| Interest expense   | (6,197 )                            | (205,448 )    | (405,329 )                         | (532,531 ) |
| Net discounts of notes payable and note receivable               | -                                   | -             | (100,000 )                         | -          |
| Derivative and warrant fair value adjustments                    | -                                   | (44,768 )     | -                                  | 932,520    |
|  | (6,195 )                            | (188,873 )    | (410,298 )                         | 582,284    |
| Loss from continuing operations                                  | (540,165 )                          | (931,697 )    | (894,319 )                         | (122,642 ) |
| Income (loss) from discontinued operations                       | -                                   | (12,093 )     | -                                  | 414,176    |
| Net income (loss)  | \$ (540,165 )                       | \$ (943,790 ) | \$ (894,319 )                      | \$ 291,534 |
| <b>Basic and Diluted Earnings per Common Share (See Note 5):</b> |                                     |               |                                    |            |
| Loss from continuing operations                                  | \$ (0.01 )                          | \$ (0.01 )    | \$ (0.01 )                         | \$ (0.01 ) |
| Income (loss) from discontinued operations                       | -                                   | 0.00          | *                                  | 0.01       |
| Net income (loss)  | \$ (0.01 )                          | \$ (0.01 )    | \$ (0.01 )                         | \$ 0.00    |

Weighted Average Shares  
Outstanding:

|                   |            |            |            |            |
|-------------------|------------|------------|------------|------------|
| Basic and Diluted | 78,155,413 | 78,016,082 | 78,155,413 | 77,815,401 |
|-------------------|------------|------------|------------|------------|

\* Represents less than \$0.01

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)

|   | Nine Months Ended September<br>30, |                   |
|---|------------------------------------|-------------------|
|   | 2011                               | 2010              |
| <b>CASH FLOW FROM OPERATING ACTIVITIES:</b>   |                                    |                   |
| Net income (loss)   | \$(894,319                         | ) \$291,534       |
| Less:   |                                    |                   |
| Income from discontinued operations   | -                                  | (414,176 )        |
| Income (loss) from continuing operations  | (894,319 )                         | (122,642 )        |
| <b>Adjustments to reconcile net income (loss) to cash used in operating activities:</b> |                                    |                   |
| Derivative and warrant fair value adjustments   | -                                  | (932,520 )        |
| Depreciation  | 22,966                             | 16,905            |
| Amortization  |                                    |                   |
| Intangible assets   | 8,452                              | 8,938             |
| Discount on convertible debt related to derivatives                                     | -                                  | 532,531           |
| Discount on secured debt  | 307,932                            | -                 |
| Net discounts of notes payable and note receivable                                      | 100,000                            | -                 |
| Share-based compensation  | 49,267                             | 38,597            |
| <b>Change in assets and liabilities:</b>  |                                    |                   |
| Accounts receivable trade   | (662,861 )                         | (61,183 )         |
| Inventory   | (10,478 )                          | 1,453             |
| Prepaid expenses and other  | 78,746                             | (5,414 )          |
| Accounts payable  | 223,300                            | (86,224 )         |
| Accrued liabilities   | 108,009                            | (99,519 )         |
| Deferred revenue  | 295,956                            | 132,752           |
| Net cash used for continuing operations   | (373,030 )                         | (576,326 )        |
| Net provided by discontinued operations   | -                                  | 415,819           |
| Net cash used for operating activities  | (373,030 )                         | (160,507 )        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                    |                   |
| Proceeds from payment of note receivable  | 3,350,000                          | -                 |
| Capital expenditures  | (56,204 )                          | (9,900 )          |
| Transfer of funds from restricted cash  | -                                  | 40,500            |
| Net cash provided by (used for) investing activities                                    | 3,293,796                          | 30,600            |
| <b>CASH FLOW FROM FINANCING ACTIVITIES:</b>   |                                    |                   |
| Repayment of notes payable  | (3,612,135 )                       | -                 |
| Dividends paid  | (125,209 )                         | -                 |
| Net cash used for financing activities  | (3,737,344 )                       | -                 |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>  | <b>(816,578 )</b>                  | <b>(129,907 )</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                                   | <b>1,010,096</b>                   | <b>792,426</b>    |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>   | <b>\$193,518</b>                   | <b>\$662,519</b>  |

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

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

|  | Nine Months Ended September |          |
|--|-----------------------------|----------|
|  | 2011                        | 2010     |
| Cash paid for:   |                             |          |
| Interest   | \$80,286                    | -        |
| <b>Noncash Investing and Financing Activities:</b>   |                             |          |
| Issuance of common stock through conversion of principal and interest on convertible promissory note | -                           | \$55,694 |

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

September 30, 2011 (Unaudited)

1. BASIS OF PRESENTATION

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

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company’s financial position and the results of its operations and cash flows for the periods presented. The balance sheet at December 31, 2010 was derived from the audited financial statements, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2010 (the “Form 10-K”), filed on March 23, 2011.

Recently Issued Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-08 “Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment”. This update simplifies the assessment of goodwill for impairment by allowing companies to consider qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount before performing the two step impairment review process. It also amends the examples of events or circumstances that would be considered in a goodwill impairment evaluation. The Company has elected to early adopt this update to be effective for the fiscal year beginning January 1, 2011. The adoption of this update did not have a material impact on our condensed consolidated financial statements.

On January 1, 2011, the Company adopted Accounting Standards Update “ASU” 2010-20, “Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.” ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity’s risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period and the disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The adoption of ASU 2010-20 did not have a significant impact on its consolidated financial statements.

On January 1, 2011, The Company adopted ASU 2010-17 “Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition.” The amendments in this Update are effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. The

adoption of ASU 2010-17 did not have a significant impact on its consolidated financial statements.

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On January 1, 2011, the Company adopted ASU 2009-13 "Multiple Element Arrangements." ASU 2009-13 addresses the determination of when the individual deliverables included in a multiple arrangement may be treated as separate units of accounting. ASU 2009-13 also modifies the manner in which the transaction consideration is allocated across separately identified deliverables and establishes definitions for determining fair value of elements in an arrangement. The adoption of ASU 2010-13 did not have a significant impact on its consolidated financial statements.

Management does not believe that any other recently issued, but not yet effective, accounting standard if currently adopted would have a material effect on the accompanying consolidated financial statements.

## 2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have incurred significant losses to date, and at September 30, 2011, we had an accumulated deficit of approximately \$51 million. In addition, broad commercial acceptance of our technology is critical to the Company's success and ability to generate future revenues. At September 30, 2011, our total cash and cash equivalents were approximately \$193,500, as compared to approximately \$1,010,000 at December 31, 2010.

As discussed below, the Company has financed itself in the past through access to the capital markets by issuing secured and convertible debt securities, as well as convertible preferred stock and common stock. We currently require approximately \$400,000 per month to conduct our operations, a monthly amount that we have been unable to achieve through revenue generation thus far in 2011.

If we continue to be unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we may 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 the 2009 to 2010 period.

Due to several factors, including our history of losses and limited revenue, our independent auditors have included an explanatory paragraph in opinions they have previously issued related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. 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 if 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.

## 3. DISCONTINUED OPERATIONS

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

During the three and nine months ended September 30, 2010, the Company recorded revenue of approximately \$0 and \$483,000 from a contract delivered under our arrangement with the Buyer which was reduced by expenses for professional fees. Income (loss) from discontinued operations totaled approximately (\$12,000) and \$414,000 for the three and nine months ended September 30, 2010. The Company does not expect any additional income from discontinued operations in the future.



## 4. SHARE BASED COMPENSATION

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

|                                       | Three Months<br>Ended September<br>30,<br>2011 | Three Months<br>Ended September<br>30,<br>2010 |
|---------------------------------------|--|--|
| Selling, general and administrative   | \$ 5,436                                       | \$ 1,468                                       |
| Research, development and engineering | 7,502  | 11,382   |
|                                       | \$ 12,938                                      | \$ 12,850                                      |

|                                       | Nine Months Ended<br>September 30,<br>2011 | Nine Months Ended<br>September 30,<br>2010 |
|---------------------------------------|--|--|
| Selling, general and administrative   | \$ 11,596                                  | \$ 12,278                                  |
| Research, development and engineering | 37,671                                     | 26,319                                     |
|                                       | \$ 49,267                                  | \$ 38,597                                  |

## Stock Option Activity

During the three and nine months ended September 30, 2011, the Company granted options to purchase 0 and 945,000 shares to employees. The options granted have a seven-year term, an exercise price of \$0.14 per share and vest over three years.

## 5. EARNINGS (LOSS) PER SHARE COMMON STOCK ("EPS")

The Company's basic EPS is calculated using net income (loss) available to common shareholders and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes the effect from potential issuance of common stock, such as stock issuable pursuant to the exercise of stock options and warrants and the assumed conversion of convertible notes and preferred stock. For the three and nine months ended September 30, 2011 and 2010, diluted per share computations are not presented since this effect would be antidilutive.

The reconciliation of the numerators of the basic and EPS calculations, due to the inclusion of preferred stock dividends and accretion was as follows for both of the following three and nine month periods ended September 30:

|  | Three Months ended<br>September 30, |      | Nine Months ended<br>September 30, |      |
|--|-------------------------------------|------|------------------------------------|------|
|  | 2011                                | 2010 | 2011                               | 2010 |

## Basic Numerator:

|                                     |               |               |               |               |
|-------------------------------------|---------------|---------------|---------------|---------------|
| Net loss from continuing operations | \$ (540,165 ) | \$ (931,697 ) | \$ (894,319 ) | \$ (122,642 ) |
|                                     | -             | (162,263 )    | -             | (481,497 )    |

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Convertible preferred stock  
dividends and accretion

|  |               |                 |               |            |
|--|---------------|-----------------|---------------|------------|
| Loss available to common<br>stockholders | \$ (540,165 ) | \$ (1,093,960 ) | \$ (894,319 ) | (604,139 ) |
| Basic Denominator                        | 78,155,413    | 78,016,082      | 78,155,413    | 77,815,401 |
| Per Share Amount                         | \$ (0.01 )    | \$ (0.01 )      | \$ (0.01 )    | \$ (0.01 ) |

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The following table summarizes the securities that were excluded from the diluted per share calculation because the effect of including these potential shares was antidilutive.

|                                 | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                 | 2011                                | 2010       | 2011                               | 2010       |
| Preferred Stock                 | -                                   | 10,185,667 | -                                  | 10,185,667 |
| Convertible Debt                | -                                   | 2,366,260  | -                                  | 2,366,260  |
| Stock Options                   | 279,978                             | 557,272    | 473,652                            | 674,641    |
| Potentially dilutive securities | 279,978                             | 13,109,199 | 473,652                            | 13,226,568 |

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

|               | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---------------|-------------------------------------|------------|------------------------------------|------------|
|               | 2011                                | 2010       | 2011                               | 2010       |
| Stock options | 3,372,140                           | 3,039,258  | 2,527,140                          | 2,844,258  |
| Warrants      | 8,250,000                           | 15,369,948 | 8,250,000                          | 15,369,948 |
| Total         | 11,622,140                          | 18,409,206 | 10,777,140                         | 18,214,206 |

## 6. NOTE RECEIVABLE

Notes receivable consisted of the following:

|                               | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------|-----------------------|----------------------|
|                               | (Unaudited)           |                      |
| Note Receivable – Current     | \$ -                  | \$ 2,167,000         |
| Note Receivable – Non-Current | -                     | 1,333,000            |
| Total                         | \$ -                  | \$ 3,500,000         |

As consideration for the Asset Sale (see “Note 3 — Discontinued Operations”), Buyer paid the Company an aggregate purchase price of approximately \$11.3 million. Of that amount, approximately \$7.0 million was paid in cash at the closing of the Asset Sale, and approximately \$300,000 was paid pursuant to the post-closing working capital adjustment provided for in the Purchase Agreement. Buyer also issued a promissory note (the “Note”) in the original principal amount of \$4 million in favor of the Company. The Note earned interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding.

Effective as of December 30, 2010, the Company entered into an Amendment and Waiver agreement (the “Amendment and Waiver”) with respect to the Note. Under the original terms of the Note, the initial scheduled repayment of principal, equal to \$1,334,000, was due to be paid to the Company on December 8, 2010. Pursuant to the Amendment and Waiver, the Company agreed to defer \$834,000 of this initial payment into three equal payments due over the course of the first three quarters of 2011, of which the first payment of \$278,000 was received in April 2011.

In exchange for this deferral, the Buyer made a principal payment of \$500,000 (received in December 2010), agreed to increase the interest rate on the deferred amount from six percent to twelve percent, and agreed to have the owner of the Parent, Silkroad Equity LLC, forfeit all of the 8,000,000 warrants previously granted to it by the Company.



Effective as of May 19, 2011, the Buyer exercised its option to prepay the balance due of \$3,222,000 under the Note. In consideration for the early payment from the Buyer, the Company accepted a \$150,000 discount on the principal amount due, of which \$50,000 was absorbed by the Secured Promissory Noteholders (see “Note 7 – Notes Payable”). The total amount received by the Company was \$3,113,654 which included principal amount of \$3,222,000, interest income of \$30,888 and a reimbursement of legal fees incurred of \$10,766 net of the discount of \$150,000.

Accrued interest receivable was \$0 and \$59,108 as of September 30, 2011 and December 31, 2010, respectively, and was included in prepaid expenses and other at December 31, 2010.

## 7. NOTES PAYABLE

### The 2010 Exchange Agreement

Effective as of December 31, 2010, the Company entered into a Securities Exchange Agreement (the “2010 Exchange Agreement”) with the Shaar Fund, Ltd. (“Shaar”) and Thomas Colatosti (“Colatosti”). Pursuant to the 2010 Exchange Agreement, Shaar exchanged all of its outstanding shares of the Company’s Series D Convertible Preferred Stock, including all accrued and unpaid dividends thereon, and the 7% Convertible Promissory Note dated as of December 28, 2009 issued by the Company to Shaar in the original principal amount of \$673,079 for an installment payment of \$500,000 and a new non-convertible 7% Secured Promissory Note in the original principal amount of \$3,157,759 (the “Shaar Note”). The installment payment was made in January 2011. Shaar also exchanged all of its existing warrants to purchase the Company’s common stock, exercisable for an aggregate of 5,108,333 shares, for a new five-year warrant to purchase up to an aggregate of 8,000,000 shares of the Company’s common stock at an exercise price of \$0.30 per share. In addition, pursuant to the 2010 Exchange Agreement, Mr. Colatosti agreed to exchange all of his outstanding shares of Series D Convertible Preferred Stock, including all accrued and unpaid dividends thereon, and the 7% Convertible Promissory Note dated as of December 28, 2009 issued by the Company to Mr. Colatosti in the original principal amount of \$64,878 for a new non-convertible 7% Secured Promissory Note in the original principal amount of \$350,804 (the “Colatosti Note”).

Pursuant to the Exchange Agreement, the Company made a cash payment to Shaar in the amount of \$500,000 at the closing of the exchange and also paid approximately \$125,209 to Shaar on January 31, 2011 in full satisfaction of the Company’s obligations to Shaar for all accrued and unpaid dividends with respect to the Company’s Series B Convertible Preferred Stock and Series C Convertible Preferred Stock formerly held by Shaar.

The principal and interest, which will also accrue at a rate of seven percent per annum under the Colatosti Note is scheduled to be repaid by the Company in cash on December 31, 2012. The Company’s obligations under the Shaar Note and the Colatosti Note are secured by substantially all of the Company’s assets and Mr. Colatosti’s right of payment under the Colatosti Note is subordinated to the rights of Shaar under the Shaar Note.

The Company recorded the warrants at their relative fair value as of the inception date of the agreement. As the warrants were classified as equity instruments, no further accounting adjustment is required. The initial fair value of the warrants was recorded as a discount to the Notes Payable and will be amortized to interest expense over the two-year expected term of the debt, using the effective interest method.

Effective as of May 20, 2011, the Company exercised its option to prepay the balance due of \$3,157,759 owed to Shaar on its Secured Promissory Note. In consideration of the \$150,000 discount granted by the Company for the early payment of the Note Receivable (see “Note 6 — Note Receivable”), the Company’s Secured Promissory Note holders agreed to absorb \$50,000 of the discount, with the remainder borne by the Company. The discount was prorated to both Note holders which reduced the Shaar payment by \$45,624 and the principle amount owed on the Colatosti Note by \$4,376. The total amount paid by the Company to Shaar was \$3,192,421 and included principal of \$3,157,759,

interest of \$80,286 less Shaar's share of the discount described above.

Notes payable consisted of the following:

|                          | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010 |
|--------------------------|--------------------------------------|----------------------|
| <b>Current Portion</b>   |                                      |                      |
| Secured promissory notes | -                                    | 2,300,000            |
| Discount                 | -                                    | (201,861 )           |
| <b>Total</b>             | <b>\$ -</b>                          | <b>\$ 2,098,139</b>  |
| <b>Long-Term Portion</b> |                                      |                      |
| Secured promissory notes | 346,428                              | 1,208,563            |
| Discount                 | -                                    | (106,071 )           |
| <b>Total</b>             | <b>\$ 346,428</b>                    | <b>\$ 1,102,492</b>  |

#### 8. SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of Biometric products. Geographically, North American sales accounted for approximately 82% and 100% of the Company's total sales for the three months ended September 30, 2011 and 2010, respectively, and were approximately 51% and 95% of the Company's total sales for the nine months ended September 30, 2011 and 2010, respectively.

#### 9. FAIR VALUES OF FINANCIAL INSTRUMENTS

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

#### 10. MAJOR CUSTOMERS

For the three months ended September 30, 2011 and 2010, one customer accounted for 22% and 28% of revenue, respectively. For the nine months ended September 30, 2011 and 2010, one customer accounted for 48% and 19% of revenue, respectively.

#### 11. RELATED PARTY TRANSACTIONS

In connection with his appointment to the Board of Directors in September 2002, and as acting Chief Financial Officer from November 2008 to December 2009, the Company has entered into a number of consulting arrangements with Mr. Thomas Colatosti. Under the most recent arrangement, which was entered into on January 12, 2010, Mr. Colatosti provides services to the Company and its subsidiary for a two-year term ending December 31, 2011 at a rate of \$5,000 per month. Mr. Colatosti has substantial experience in the biometric industry and in addition to his role as the Chairman of the Board of Directors of the Company, provides extensive service to the Company in the areas of strategic planning and corporate finance.

#### 12. SUBSEQUENT EVENTS

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



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

CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

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

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

OVERVIEW

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

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

In partnerships with OEMs, integrators, and solution providers, we provide biometric software solutions to private and public sector customers. BIO-key provides the ability to positively identify individuals before granting access to valuable corporate resources, web portals or applications in seconds. Powered by our patented Vector Segment Technology™ our VST™, WEB-key® and BSP development kits are fingerprint biometric solutions that provide true interoperability with all major reader manufacturers, enabling application developers and integrators to seamlessly integrate fingerprint biometrics into virtually any application.

On August 15, 2011, the Company announced that it has signed a letter of intent to acquire Montreal-based S.I.C. Biometrics Inc. If such a combination is completed, BIO-key expects that its overall market reach would be strengthened, expanding opportunities for new projects and partnerships that could be fully satisfied via complete solutions for mobility, access control and consumer security. S.I.C., founded in 1999, designs, manufactures and internationally commercializes biometrics security products, including biometric plug-in mobile fingerprint scanners, biometric proximity cards and access control solutions. S.I.C. is credited with developing the first fingerprint reader for Apple mobile devices. The terms of the definitive acquisition agreements will be made public when fully

negotiated and signed. In addition to due diligence and definitive documentation, the transaction will be subject to customary closing conditions, including any necessary regulatory approvals.

## CRITICAL ACCOUNTING POLICIES

For detailed information on our critical accounting policies and estimates, see our financial statements and notes thereto included in this Report and in our Annual Report on Form 10-K, for the year ended December 31, 2010. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-K filed on March 23, 2011.

## RECENT ACCOUNTING PRONOUNCEMENTS

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-08 “Intangibles–Goodwill and Other (Topic 350): Testing Goodwill for Impairment”. This update simplifies the assessment of goodwill for impairment by allowing companies to consider qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount before performing the two step impairment review process. It also amends the examples of events or circumstances that would be considered in a goodwill impairment evaluation. The Company has elected to early adopt this update to be effective for the fiscal year beginning January 1, 2011. The adoption of this update did not have a material impact on our condensed consolidated financial statements.

On January 1, 2011, the Company adopted Accounting Standards Update (ASU) 2010-20 “Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.” ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity’s risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period and the disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The adoption of ASU 2010-20 did not have a significant impact on its consolidated financial statements.

On January 1, 2011, the Company adopted ASU 2010-17 “Revenue Recognition–Milestone Method (Topic 605): Milestone Method of Revenue Recognition.” The amendments in this Update are effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. The adoption of ASU 2010-17 did not have a significant impact on its consolidated financial statements.

On January 1, 2011, the Company adopted ASU 2009-13 “Multiple Element Arrangements.” ASU 2009-13 addresses the determination of when the individual deliverables included in a multiple arrangement may be treated as separate units of accounting. ASU 2009-13 also modifies the manner in which the transaction consideration is allocated across separately identified deliverables and establishes definitions for determining fair value of elements in an arrangement. The adoption of ASU 2010-13 did not have a significant impact on its consolidated financial statements.

Management does not believe that any other recently issued, but not yet effective, accounting standard if currently adopted would have a material effect on the accompanying consolidated financial statements.

## RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2011 AS COMPARED TO SEPTEMBER 30, 2010

## Consolidated Results of Operations - Percent Trend

|                                       | Three Months Ended September 30, |   |      |   |
|---------------------------------------|----------------------------------|---|------|---|
|                                       | 2011                             |   | 2010 |   |
| Revenues                              |                                  |   |      |   |
| Services                              | 40                               | % | 21   | % |
| License fees and other                | 60                               | % | 79   | % |
|                                       | 100                              | % | 100  | % |
| Costs and other expenses              |                                  |   |      |   |
| Cost of services                      | 7                                | % | 6    | % |
| Cost of license fees and other        | 30                               | % | 32   | % |
|                                       | 37                               | % | 38   | % |
| Gross Profit                          | 63                               | % | 62   | % |
| Operating expenses                    |                                  |   |      |   |
| Selling, general and administrative   | 109                              | % | 150  | % |
| Research, development and engineering | 47                               | % | 48   | % |
|                                       | 156                              | % | 198  | % |
| Operating loss                        | -93                              | % | -136 | % |
| Other deductions                      |                                  |   |      |   |
| Total other deductions                | -1                               | % | -35  | % |
| Loss from continuing operations       | -94                              | % | -171 | % |
| Loss from discontinued operations     | -                                | % | -2   | % |
| Net loss                              | -94                              | % | -173 | % |

|                    | Three months ended<br>September 30, |            |            |          |
|--------------------|-------------------------------------|------------|------------|----------|
|                    | 2011                                | 2010       | \$ Change  | % Change |
| Revenues           |                                     |            |            |          |
| Service            | \$ 229,422                          | \$ 112,090 | \$ 117,332 | 105 %    |
| License & other    | 344,666                             | 434,286    | (89,620 )  | -21 %    |
| Total Revenue      | \$ 574,088                          | \$ 546,376 | \$ 27,712  | 5 %      |
| Cost of goods sold |                                     |            |            |          |
| Service            | \$ 42,719                           | \$ 30,203  | \$ 12,516  | 41 %     |
| License & other    | 168,167                             | 175,967    | (7,800 )   | -4 %     |
| Total COGS         | \$ 210,886                          | \$ 206,170 | \$ 4,716   | 2 %      |

## Revenues

For the three months ended September 30, 2011 and 2010, service revenues included approximately \$159,000 and \$106,000, respectively, of recurring maintenance and support revenue, and approximately \$70,000 and \$6,000 of



non-recurring custom services revenue for the three months ended September 30, 2011 and 2010, respectively. Recurring service revenue increased 50% for these three month periods from 2010 to 2011 as the Company continued to bundle maintenance agreements to its expanding customer license base, and renewed existing maintenance agreements from its legacy customers.

For the three months ended September 30, 2011, license and other revenue (comprised of third party hardware and royalty) decreased as a result of a decrease in our core software revenue. The Company realized an approximately \$82,000 decrease (53%) in its core software license. Third-party hardware sales decreased by approximately \$5,500 (2%), as a result of decreased new license orders with associated hardware. The Company's royalty income was derived from an OEM agreement, and resulted in a 7% decrease in revenue to \$22,989, from \$24,825 for the three months ended September 30, 2011 and 2010, respectively.

#### Costs of goods sold

For the three months ended September 30, 2011, cost of services increased approximately \$12,500 from the same period in 2010 due to increased customer support for the expanding customer base.

License and other costs decreased \$8,000 for the three months ended September 30, 2011 from the same period in 2010 due to a decrease in costs for temporary outside services required to support specific customer order requirements and by a decrease in hardware orders and associated costs.

#### Selling, general and administrative

|                                     | Three months ended<br>September 30, |            |               |          |
|-------------------------------------|-------------------------------------|------------|---------------|----------|
|                                     | 2011                                | 2010       | \$ Change     | % Change |
| Selling, general and administrative | \$ 626,589                          | \$ 817,348 | \$ (190,759 ) | -23 %    |

Selling, general and administrative expenses decreased by 23% for the three months ended September 30, 2011 from the same period in 2010. Reductions included referral fees and commission expense related to decreased license sales, reduction in legal and accounting fees associated with the change in the accounting firm in 2010, a reduction in professional fees, show attendance and public relations expenses.

#### Research, development and engineering

|                                       | Three months ended<br>September 30, |            |           |          |
|---------------------------------------|-------------------------------------|------------|-----------|----------|
|                                       | 2011                                | 2010       | \$ Change | % Change |
| Research, development and engineering | \$ 270,583                          | \$ 265,682 | \$ 4,901  | 2 %      |

For the three months ended September 30, 2011, research, development and engineering costs increased 2% from the same period in 2010 primarily related to payroll overhead expenses.

## Other income and expense

|   | Three months ended<br>September 30, |               |            |          |   |
|---|-------------------------------------|---------------|------------|----------|---|
|   | 2011                                | 2010          | \$ Change  | % Change |   |
| Amortization of discount                      | \$-                                 | \$ (166,200 ) | \$ 166,200 | -100     | % |
| Interest income                               | 2                                   | 61,343        | (61,341 )  | -100     | % |
| Interest expense                              | (6,197 )                            | (39,248 )     | 33,051     | -84      | % |
| Derivative and warrant fair value adjustments | -                                   | (44,768 )     | 44,768     | -100     | % |
| Total   | \$(6,195 )                          | (188,873 )    | \$ 182,678 | -97      | % |

For the quarter ended September 30, 2010, the derivative and warrant fair value income was attributable to embedded derivatives and detachable warrants issued with convertible debt in 2005, 2006 and 2009. The fair value of the derivatives fluctuated 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. Our convertible debt was converted to the Note Payable which was discounted as a result of the detachable warrants associated with the conversion. For the quarters ended September 30, 2011 and 2010, the amortization of the discount was attributable to the Note Payable, including the balance of the unamortized debt discount due to the accelerated payment, and the convertible note, respectively.

For the quarters ended September 30, 2011 and 2010, the interest income was attributable to the Note Receivable, which was fully paid in May 2011. The interest expense in the above table was attributable to the Note Payable, of which approximately \$346,000 remains outstanding as of September 30, 2011.

## NINE MONTHS ENDED SEPTEMBER 30, 2011 AS COMPARED TO SEPTEMBER 30, 2010

## Consolidated Results of Operations - Percent Trend

|                                       | Nine Months Ended September 30, |   |      |   |
|---------------------------------------|---------------------------------|---|------|---|
|                                       | 2011                            |   | 2010 |   |
| Revenues                              |                                 |   |      |   |
| Services                              | 18                              | % | 11   | % |
| License fees and other                | 82                              | % | 89   | % |
|                                       | 100                             | % | 100  | % |
| Costs and other expenses              |                                 |   |      |   |
| Cost of services                      | 4                               | % | 3    | % |
| Cost of license fees and other        | 17                              | % | 11   | % |
|                                       | 21                              | % | 14   | % |
| Gross Profit                          | 79                              | % | 86   | % |
| Operating expenses                    |                                 |   |      |   |
| Selling, general and administrative   | 67                              | % | 82   | % |
| Research, development and engineering | 28                              | % | 28   | % |
|                                       | 95                              | % | 110  | % |
| Operating loss                        | -16                             | % | -24  | % |
| Other deductions                      |                                 |   |      |   |
| Total other deductions                | -14                             | % | 20   | % |
| Loss from continuing operations       | -30                             | % | -4   | % |
| Income from discontinued operations   | -                               | % | 14   | % |
| Net Income (loss)                     | -30                             | % | 10   | % |

|                    | Nine months ended<br>September 30, |              |            |          |
|--------------------|------------------------------------|--------------|------------|----------|
|                    | 2011                               | 2010         | \$ Change  | % Change |
| Revenues           |                                    |              |            |          |
| Service            | \$ 538,394                         | \$ 316,478   | \$ 221,916 | 70 %     |
| License & other    | 2,424,959                          | 2,639,124    | (214,165 ) | -8 %     |
| Total Revenue      | \$ 2,963,353                       | \$ 2,955,602 | \$ 7,751   | 0 %      |
| Cost of goods sold |                                    |              |            |          |
| Service            | \$ 108,534                         | \$ 80,391    | \$ 28,143  | 35 %     |
| License & other    | 509,799                            | 339,720      | 170,079    | 50 %     |
| Total COGS         | \$ 618,333                         | \$ 420,111   | \$ 198,222 | 47 %     |

## Revenues

For the nine months ended September 30, 2011 and 2010, service revenues included approximately \$452,000 and \$296,000, respectively, of recurring maintenance and support revenue, and approximately \$86,000 and \$21,000, respectively, of non-recurring custom services revenue. Recurring service revenue increased 53% from 2010 to 2011 as the Company continued to bundle maintenance agreements to its expanding customer license base, and renewed existing maintenance agreements from its legacy customers.



For the nine months ended September 30, 2011 and 2010, license and other revenue (comprised of third party hardware and royalty) decreased as a result of several contributing factors. The Company realized an approximately \$572,000 decrease (27%) in its core software license revenue primarily as a result of one large order from single new customer in 2011 as compared to two large orders from new customers in 2010. For the nine months ended September 30, 2011 and 2010 we shipped orders from McKesson for their continued deployment of our identification technology in their AccuDose® product line, and for continued expansion of biometric ID deployments with commercial partners ChoicePoint /Nexis Lexis, Educational Biometric Technology, and Identimetrics. Third-party hardware sales increased by approximately \$351,000 (82%), as a result of increased demand from an existing OEM partner and expansion of several Healthcare deployments which we do not expect at the same rate of increase going forward. The Company's royalty income was derived from an OEM agreement, and resulted in a 19% increase in revenue to approximately \$79,000 from \$72,000 for the nine months ended September 30, 2011 and 2010, respectively.

#### Costs of goods sold

For the nine months ended September 30, 2011, cost of services increased approximately \$28,000 from the same period in 2010 due to increased customer support for the expanding customer base. License and other costs increased \$170,000 for the nine months ended September 30, 2011 from the same period in 2010 due to an increase in hardware orders, offset by a decrease in the specific customer requirements for third party software.

#### Selling, general and administrative

|                                     | Nine months ended<br>September 30, |              |               |          |
|-------------------------------------|------------------------------------|--------------|---------------|----------|
|                                     | 2011                               | 2010         | \$ Change     | % Change |
| Selling, general and administrative | \$ 1,974,552                       | \$ 2,414,810 | \$ (440,258 ) | -18 %    |

Selling, general and administrative costs for the nine months ended September 30, 2011 decreased 18% from the same period in 2010. Reductions included referral fees and commission expense related to decreased license sales, reduction in legal and accounting fees associated with the change in the accounting firm in 2010, a reduction in professional fees, show attendance and public relations expenses.

#### Research, development and engineering

|                                       | Nine months ended<br>September 30, |            |           |          |
|---------------------------------------|------------------------------------|------------|-----------|----------|
|                                       | 2011                               | 2010       | \$ Change | % Change |
| Research, development and engineering | \$ 854,489                         | \$ 825,607 | \$ 28,882 | 3 %      |

For the nine months ended September 30, 2011, research, development and engineering costs increased 3% from the nine months ended September 30, 2010 related to temporary outside services expenses for specific new projects and payroll overhead expenses.



## Other income and expense

|  | Nine months ended<br>September 30, |                   | \$ Change            | % Change      |
|--|------------------------------------|-------------------|----------------------|---------------|
|  | 2011                               | 2010              |                      |               |
| Amortization of discount                         | \$ (307,932 )                      | \$ (493,283 )     | \$ 185,351           | 38 %          |
| Interest income                                  | 95,031                             | 182,295           | (87,264 )            | -48 %         |
| Interest expense                                 | (97,397 )                          | (39,248 )         | (58,149 )            | 148 %         |
| Net discounts of notes payable<br>and receivable | (100,000 )                         | -                 | (100,000 )           | n/a           |
| Derivative and warrant fair<br>value adjustments | -                                  | 932,520           | (932,520 )           | -100 %        |
| <b>Total</b>                                     | <b>\$ (410,298 )</b>               | <b>\$ 582,284</b> | <b>\$ (992,582 )</b> | <b>-170 %</b> |

For the nine months ended September 30, 2010, the derivative and warrant fair value income was attributable to embedded derivatives and detachable warrants issued with convertible debt in 2005, 2006 and 2009. The fair value of the derivatives fluctuated 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. Our convertible debt was converted to the Note Payable which was discounted as a result of the detachable warrants associated with the conversion. For the nine months ended September 30, 2011 and 2010, the amortization of the discount, which was included in interest expense in the Statements of Operations, was attributable to the Note Payable and the convertible note, respectively.

For the nine months ended September 30, 2011 and 2010, the interest income was attributable to the Note Receivable, which was fully paid in May 2011. The interest expense in the above table was attributable to the Note Payable, of which approximately \$346,000 remains outstanding as of September 30, 2011.

For the nine months ended September 30, 2011, the net discounts of notes payable and receivable was a non-cash item with respect to the value of the net early payment discount granted to the holder of the note receivable.

## LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended September 30, 2011, net cash used in continuing operations was approximately \$373,000. The cash used for continuing operations was primarily due to the following items:

Negative cash flows related to an increase in accounts receivable of approximately \$663,000, due to a large partially paid order received late in the first quarter; and

Positive cash flows from an increase in accounts payable and accrued expenses of approximately \$331,000, attributable to the accrued commission and an increase of approximately \$223,000 in accounts payable of which approximately \$90,000 is for third party hardware shipped late in the quarter, both due to the orders received late in the September 2011 quarter, and an increase in deferred revenue for maintenance renewals and a new prepaid order.

The Company recorded approximately \$49,000 of charges during the first nine months of 2011 for the expense of issuing options to employees for services.



The cash provided by investing activities of \$3,293,796 was the result of the early receipt of proceeds from the note receivable of \$3,350,000 net of capital expenditures of \$56,204.

The cash used for financing activities of \$3,737,344 included the early repayment of the Shaar note of \$3,612,135 and outstanding dividends of \$125,209.

Working capital at September 30, 2011 was approximately \$(207,000), as compared to approximately \$88,000 at December 31, 2010. The decline was driven by both the reduction in cash, and the increase in Accounts Receivable with a greater amount of liability in accounts payable and deferred revenue.

#### S.I.C BIOMETRICS – CASH AND EQUITY

We anticipate establishing additional financing to complete this acquisition. Such additional financing is most likely to consist of secured term loans, but that may change prior to the closing of the acquisition. We expect some capital expenditures during the next twelve months for equipment purchases.

#### Liquidity outlook

At September 30, 2011, our total of cash and cash equivalents was \$193,518, as compared to \$1,010,096 at December 31, 2010.

As discussed above, the Company has financed itself in the past through access to the capital markets by issuing convertible debt securities, convertible preferred stock and common stock. We currently require approximately \$400,000 per month to conduct our operations. During the first nine months of the 2011, we generated approximately \$2,963,000 of revenue, which is below our average monthly requirements.

If we are unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we may 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 the 2009 to 2010 period.

Due to several factors, including our history of losses and limited revenue, our independent auditors have included an explanatory paragraph in opinions they have previously issued related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. 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 4. CONTROLS AND PROCEDURES

##### Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer (“CEO”) and Chief Financial Officer, (“CFO”) evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2011. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of September 30, 2011, our CEO and CFO concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

No change in our internal control over financial reporting occurred during the fiscal quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 6. EXHIBITS

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

SIGNATURES

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

BIO-Key International, Inc.

Dated: November 14, 2011

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

Dated: November 14, 2011

/s/ Cecilia Welch  
Cecilia Welch  
Chief Financial Officer

EXHIBIT INDEX

| Exhibit No. | Description  |
|-------------|--|
| 31.1(1)     | Certificate of CEO of Registrant required under Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended |
| 31.2 (1)    | Certificate of CFO of Registrant required under Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended |
| 32.1(1)     | Certificate of CEO of Registrant required under 18 U.S.C. Section 1350   |
| 32.2 (1)    | Certificate of CFO of Registrant required under 18 U.S.C. Section 1350   |
| 101.INS**   | XBRL Instance  |
| 101.SCH**   | XBRL Taxonomy Extension Schema   |
| 101.CAL**   | XBRL Taxonomy Extension Calculation  |
| 101.DEF**   | XBRL Taxonomy Extension Definition   |
| 101.LAB**   | XBRL Taxonomy Extension Labels   |
| 101.PRE**   | XBRL Taxonomy Extension Presentation   |

(1) Filed herewith

\*\* information is furnished and not filed or a part of a registration statement or prospectus for purposes of XBRL sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.