

BIO KEY INTERNATIONAL INC

Form 10-Q

May 14, 2010

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U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

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

For the Transition Period from _____ to _____

Commission file number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Exact Name of registrant as specified in its charter)

DELAWARE
(State or Other Jurisdiction of
Incorporation of Organization)

41-1741861
(IRS Employer
Identification Number)

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

(Address of Principal Executive Offices)

(732) 359-1100

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

Number of shares of Common Stock, \$.0001 par value per share, outstanding as of May 12, 2010 were 77,713,398

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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**

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	March 31, 2010 (Unaudited)	December 31, 2009 (Audited)
ASSETS		
Cash and cash equivalents	\$ 487,971	\$ 792,426
Restricted cash	40,500	40,500
Accounts receivable, net of allowance for doubtful accounts of \$11,526 at March 31, 2010 and December 31, 2009	1,397,005	847,215
Note receivable, current portion	1,334,000	1,334,000
Inventory	11,858	14,935
Prepaid expenses and other	148,875	123,911
Total current assets	3,420,209	3,152,987
Equipment and leasehold improvements, net	34,355	39,243
Deposits and other assets	8,712	8,712
Note receivable, net of current portion	2,666,000	2,666,000
Intangible assets less accumulated amortization	227,280	230,259
Total non-current assets	2,936,347	2,944,214
TOTAL ASSETS	\$ 6,356,556	\$ 6,097,201
LIABILITIES		
Accounts payable	\$ 269,660	\$ 340,241
Accrued liabilities	549,641	708,765
Deferred revenue	304,972	200,996
Convertible notes, derivatives and warrants	381,650	471,483
Redeemable preferred stock derivatives	93,211	563,599
Total current liabilities	1,599,134	2,285,084
Warrants		63,901
Deferred revenue	5,939	9,391
Total non-current liabilities	5,939	73,292
TOTAL LIABILITIES	\$ 1,605,073	\$ 2,258,376
Commitments and contingencies		
Series D redeemable convertible preferred stock: authorized, 100,000 shares (liquidation preference of \$100 per share); issued and outstanding 30,557 shares of \$.0001 par value at March 31, 2010 and December 31, 2009		
	2,789,328	2,630,593
	2,789,328	2,630,593
STOCKHOLDERS EQUITY:		
Common stock authorized, 170,000,000 shares; issued and outstanding; 77,713,398 of \$.0001 par value at March 31, 2010 and December 31, 2009	7,771	7,771
Additional paid-in capital	51,041,119	51,187,754
Accumulated deficit	(49,086,735)	(50,087,293)
TOTAL STOCKHOLDERS EQUITY	1,962,155	1,108,232
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 6,356,556	\$ 6,097,201

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

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

	Three months ended March 31,	
	2010	2009
Revenues		
Services	\$ 92,043	\$ 131,350
License fees and other	884,132	406,844
	976,175	538,194
Costs and other expenses		
Cost of services	30,429	17,417
Cost of license fees and other	79,671	119,662
	110,100	137,079
Gross Profit	866,075	401,115
Operating Expenses		
Selling, general and administrative	700,021	878,462
Research, development and engineering	284,788	250,267
	984,809	1,128,729
Operating loss	(118,734)	(727,614)
Other income (expenses)		
Derivative and warrant fair value adjustments	786,710	(35,330)
Interest income	60,000	
Interest expense	(162,736)	(23,494)
Other		(3,375)
	683,974	(62,199)
Income (loss) from continuing operations	565,240	(789,813)
Income from discontinued operations	435,318	1,011,862
Net Income	\$ 1,000,558	\$ 222,049
Basic Earnings(Loss) per Common Share:		
Income (loss) from continuing operations	0.005	(0.02)
Income from discontinued operations	0.006	0.02
Net earnings per Common Share	\$ 0.011	\$ 0.00
Diluted Earnings(Loss) per Common Share:		
Income (loss) from continuing operations	(0.002)	(0.02)
Income from discontinued operations	0.006	0.02
Net earnings per Common Share	\$ 0.004	\$ 0.00
Weighted Average Shares Outstanding:		
Basic	77,713,398	68,477,547
Diluted	91,207,492	68,477,547

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

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

	Three Months Ended March 31,	
	2010	2009
CASH FLOW FROM OPERATING ACTIVITIES:		
Net income	\$ 1,000,558	\$ 222,049
Less:		
Income from discontinued operations	(435,318)	(1,011,862)
Income (loss) from continuing operations	\$ 565,240	\$ (789,813)
Adjustments to reconcile net income (loss) to cash used for operating activities:		
Derivative and warrant fair value adjustments	(786,710)	35,330
Depreciation	7,962	5,809
Amortization		
Intangible assets	2,979	2,812
Discounts on convertible debt related to derivatives	162,588	
Share-based compensation	11,490	49,590
Change in assets and liabilities:		
Accounts receivable trade	(549,790)	(238,692)
Inventory	3,077	955
Prepaid expenses and other	(24,964)	(19,639)
Accounts payable	(70,581)	17,049
Accrued liabilities	(159,124)	135,206
Deferred revenue	100,524	(310,116)
Net cash used for continuing operations	(737,309)	(1,111,509)
Net cash provided by discontinued operations	435,928	765,542
Net cash used for operating activities	(301,381)	(345,967)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(3,074)	(2,872)
Deposits		(300)
Net cash used for continuing operations	(3,074)	(3,172)
Net cash used for discontinued operations		(1,899)
Net cash used for investing activities	(3,074)	(5,071)
CASH FLOW FROM FINANCING ACTIVITIES:		
Dividends		(37,207)
Net cash used for continuing operations		(37,207)
Net cash used for financing activities		(37,207)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(304,455)	(388,245)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	792,426	1,712,912
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 487,971	\$ 1,324,667

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

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	Three Months Ended March 31,	
	2010	2009
Cash paid for:		
Interest	\$	\$ 22,793
Noncash Investing and Financing Activities:		
Issuance of common stock in exchange for Series A, B and C preferred stock and cumulative dividends in arrears, thereon		149,566

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

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BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2010(Unaudited)

1. BASIS OF PRESENTATION

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

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company's financial position and the results of its operations and cash flows for the periods presented. The balance sheet at December 31, 2009 was derived from the audited financial statements, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009 (the Form 10-K), filed on March 26, 2010.

Recently Issued Accounting Pronouncements

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

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

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have incurred significant losses to date, and at March 31, 2010, we had an accumulated deficit of approximately \$49 million. In addition, broad commercial acceptance of our technology is critical to the Company's success and ability to generate future revenues. If the Company is unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained by the Company in order to meet its needs, or that such financing would not be dilutive to existing shareholders.

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern, and assumes continuity of operations, realization of assets and the satisfaction of liabilities and commitments in the normal course

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of business. The matters described in the preceding paragraph raise substantial doubt about the Company's ability to continue as a going concern. Recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheets is dependent upon the Company's ability to meet its financing requirements on a continuing basis, and maintain profitability in its future operations. The accompanying condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

3. DISCONTINUED OPERATIONS

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

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

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

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

During the period ended March 31, 2010, the Company recorded income of approximately \$483,000 from a contract delivered under our arrangement with Buyer which was reduced by expenses for professional fees, resulting in net income from discontinued operations of approximately \$435,000. The Company does not expect any additional income from discontinued operations in the future. The Company and Buyer have agreed to extend the period that Buyer can assert potential post closing purchase price adjustments to May 31, 2010.

4. SHARE BASED COMPENSATION

The Company accounts for share based compensation in accordance with the provisions of ASC 718-10, Compensation – Stock Compensation, which requires measurement of compensation cost for all stock awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The majority of our share-based compensation arrangements vest over either a three or four year vesting schedule. The Company expenses its share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant. The fair value of stock options is determined using the Black-Scholes valuation model and requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (the expected option term), the estimated volatility of our common stock price over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield. Changes in these

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subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized as an expense in the consolidated statements of operations. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, are likely to change our valuation assumptions used to value employee stock-based awards granted in future periods. The values derived from using the Black-Scholes model are recognized as expense over the service period, net of estimated forfeitures (the number of individuals that will ultimately not complete their vesting requirements). The estimation of stock awards that will ultimately vest requires significant judgment. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

The compensation expense recognized under ASC 718 increased the Company's operating loss by \$11,490 and \$49,590 with no effect per share (basic and diluted) for the three months ended March 31, 2010 and 2009, respectively.

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

	Three Months Ended March 31,	
	2010	2009
Cost of services	\$	\$
Selling, general and administrative	5,348	40,577
Research, development and engineering	6,142	9,013
	\$ 11,490	\$ 49,590

Valuation Assumptions for Stock Options

For the three months ended March 31, 2010 and 2009, 410,000 and 775,000 stock options were granted, respectively. The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended	
	March 31,	
	2010	2009
Risk free interest rate	2.36%	1.83%
Expected life of options (in years)	4.25	2.5-3.5
Expected dividends	0%	0%
Volatility of stock price	115%	87.41%

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, a total of 750,000 shares of common stock were reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which could not be below 100% of fair market value for incentive stock options and 50% for all other options. The term of stock options granted could not exceed ten years. Options issued under the 1996 Plan vested pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined in the 1996 Plan, all options outstanding vest immediately. The 1996 Plan expired in May 2005.

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1999 Stock Option Plan

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

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 been presented to stockholders for approval and thus incentive stock options are not available under this plan. Under the terms of the 2004 Plan, a total of 4,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of stock options granted may not exceed ten years. Options issued under the 2004 Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined in the 2004 Plan, all options outstanding vest immediately. The 2004 Plan expires in October 2014.

Non-Plan Stock Options

Periodically, the Company has granted options outside of the 1996, 1999, and 2004 Plans to various employees and consultants. In the event of a change in control, as defined in the relevant agreements with the recipients, 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, 2010:

	1996 Plan	1999 Plan	Number of Options		Total	Weighted average exercise price	Weighted average remaining life (in years)	Aggregate intrinsic value
			2004 Plan	Non Plan				
Outstanding, as of December 31, 2009	45,000	500,000	2,073,189	1,329,841	3,948,030	\$ 0.24		
Granted			410,000		410,000	0.45		
Exercised								

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Forfeited									
Expired			(2,500)		(2,500)		0.67		
Outstanding, as of									
March 31, 2010	45,000	500,000	2,480,689	1,329,841	4,355,530	\$	0.26	4.34	\$ 151,676
Vested or expected to vest at March 31, 2010									
					4,153,717	\$	0.25	4.24	\$ 146,337
Exercisable at March 31, 2010					3,559,362	\$	0.26	3.96	\$ 119,560

The options outstanding and exercisable at March 31, 2010 were in the following exercise price ranges:

Range of exercise prices	Number of shares	Options Outstanding		Options Exercisable	
		Weighted average exercise price	Weighted average remaining life (in years)	Number exercisable	Weighted average exercise price
\$ 0.07-0.21	1,596,272	\$ 0.11	5.41	1,210,104	\$ 0.11
0.22-0.40	2,299,258	0.30	3.32	2,229,258	0.30
0.41-0.68	385,000	0.46	0.30	45,000	0.47
0.69-0.94	75,000	0.94	1.59	75,000	0.94
\$ 0.07-0.94	4,355,530			3,559,362	

The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.20 as of March 31, 2010 which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of March 31, 2010 was 1,185,771.

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The weighted average fair value of options granted during the three months ended March 31, 2010 and 2009 was \$0.162 and \$0.056 per share, respectively. The total fair value of shares vested during the three months ended March 31, 2010 and 2009 was \$8,030 and \$81,534, respectively.

As of March 31, 2010, future compensation cost related to nonvested stock options is approximately \$83,413 and will be recognized over an estimated weighted average period of approximately 1.48 years.

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

The Company's basic EPS is calculated using net income (loss) available to common shareholders and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes the effect from potential issuance of common stock, such as stock issuable pursuant to the exercise of stock options and warrants and the assumed conversion of convertible notes and preferred stock.

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

	Three Months ended March 31,	
	2010	2009
Basic Numerator:		
Net income (loss) from continuing operations	\$ 565,240	\$ (789,813)
Convertible preferred stock dividends and accretion	(158,735)	(361,618)
Loss available to common stockholders	\$ 406,505	\$ (1,151,431)
Basic Denominator:	77,713,398	68,477,547
Per Share Amount	\$ 0.005	\$ (0.02)

The following table summarizes the potential weighted average shares of common stock that were included in the diluted per share calculation for three months ended March 31, 2010 and excluded from the three months ended March 31, 2009 because the effect of including these potential shares was antidilutive.

	Three Months Ended March 31,	
	2010	2009
Preferred Stock	10,185,667	33,155,440
Convertible Debt	2,459,857	
Stock Options	848,570	
Warrants		

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Potentially dilutive securities	13,494,094	33,155,440
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	Three Months ended March 31,	
	2010	2009
Dilutive Numerator:		
Net income (loss) from continuing operations	\$ 565,240	\$ (789,813)
Convertible preferred stock dividends and accretion	(158,735)	(361,618)
Convertible debt interest recognized	162,588	
Reversed derivative change in fair market value	(698,884)	
Loss available to common stockholders	\$ (129,791)	\$ (1,151,431)
Dilutive Denominator:	91,207,492	68,477,547
Per Share Amount	\$ 0.00	\$ (0.02)

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

	Three Months Ended March 31,	
	2010	2009
Stock options	2,759,258	7,353,933
Warrants	16,775,791	6,136,899
Total	19,535,049	13,490,832

6. NOTE RECEIVABLE

Notes receivable consisted of the following:

	March 31, 2010	December 31, 2009
Note Receivable - Current	\$ 1,334,000	\$ 1,334,000
Note Receivable - Non-Current	2,666,000	2,666,000
Total	\$ 4,000,000	\$ 4,000,000

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 working capital adjustment provided for in the Purchase Agreement. Buyer issued a promissory note (the Note) in the original principal amount of \$4.0 million in favor of the Company. The Note is to be paid in three equal annual installments beginning on the first anniversary of the closing and will bear interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding. The Note is guaranteed by SilkRoad, a private investment firm and a principal owner of Buyer, and is secured by all of the intellectual property assets of the Law Enforcement division that were sold to Buyer.

7. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consisted of the following:

March 31, 2010	December 31, 2009
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Equipment	\$	239,022	\$	235,948
Furniture and fixtures		99,199		99,199
Software		28,624		28,624
Leasehold improvements		39,975		39,975
		406,820		403,746
Less accumulated depreciation and amortization		(372,465)		(364,503)
Total	\$	34,355	\$	39,243

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8. OTHER INTANGIBLE ASSETS

Other intangible assets consisted of the following:

	March 31, 2010			December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Patents and patents pending	287,248	(59,968)	227,280	287,248	(56,989)	230,259
Total	\$ 287,248	\$ (59,968)	\$ 227,280	\$ 287,248	\$ (56,989)	\$ 230,259

Aggregate amortization expense for the three months ended March 31, 2010 and 2009, was \$2,979 and \$2,796 respectively.

9. RESTRICTED CASH

During 2008, the Company extended its property lease at the Marlborough, MA location. Pursuant to the agreement BIO-key was to maintain a security deposit in the form of an irrevocable letter of credit in the amount of \$40,500. However, BIO-key and the landlord for the property subsequently agreed to have BIO-key place the funds in a third party escrow account, to be returned at the conclusion of the lease term, in August 2011. Pursuant to the sale of the Company's Law Enforcement Business to Buyer in December 2009 (see Note 3 Discontinued Operations), the Company is no longer situated at this location, and is in the process of assigning its obligations under the lease to Buyer. Accordingly, the balance is recorded as the current asset, Restricted cash as at March 31, 2010.

10. NOTES PAYABLE, CONVERTIBLE DEBT FINANCING / WARRANTS

Convertible Promissory Notes

Convertible note financing and warrants consisted of the following:

	March 31, 2010	December 31, 2009
Current Portion		

9. RESTRICTED CASH

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2005			
FMV of warrants	\$	2,604	\$ 47,773
2006			
FMV of warrants		21,244	
2009			
Convertible promissory notes		737,957	737,957
Discount		(496,550)	(659,138)
FMV of embedded derivatives			