BIO KEY INTERNATIONAL INC
Form 10-Q
November 12, 2010
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U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2010

or

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

For the Transition Period from to

Commission file number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE	**41-1741861**

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

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

(Address of Principal Executive Offices)

(732) 359-1100

(Issuer s Telephone Number)

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

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 o No o

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 o	Accelerated filer o
Non-accelerated filer o	Smaller Reporting Company x

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

Number of shares of Common Stock, $.0001 par value per share, outstanding as of November 12, 2010 were 78,155,413.

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PART I FINANCIAL INFORMATION

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

		September 30, 2010 (Unaudited)		December 31, 2009
ASSETS				
Cash and cash equivalents	$	662,519	$	792,426
Restricted cash				40,500
Accounts receivable, net of allowance for doubtful accounts of $11,526 at September 30, 2010 and December 31, 2009		908,398		847,215
Note receivable, current portion		1,334,000		1,334,000
Inventory		13,482		14,935
Prepaid expenses and other		129,325		123,911
Total current assets		3,047,724		3,152,987
Equipment and leasehold improvements, net		32,238		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		221,321		230,259
Total non-current assets		2,928,271		2,944,214
TOTAL ASSETS	$	5,975,995	$	6,097,201
LIABILITIES				
Accounts payable	$	254,017	$	340,241
Accrued liabilities		621,142		708,765
Deferred revenue		337,871		200,996
Convertible notes, derivatives and warrants		610,078		471,483
Redeemable preferred stock derivatives		21,327		563,599
Total current liabilities		1,844,435		2,285,084
Warrants				63,901
Deferred revenue		5,268		9,391
Total non-current liabilities		5,268		73,292
TOTAL LIABILITIES		1,849,703		2,358,376
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 September 30, 2010 and December 31, 2009		3,112,090		2,630,593
		3,112,090		2,630,593
STOCKHOLDERS EQUITY:				
Common stock authorized, 170,000,000 shares; issued and outstanding; 78,155,413 and 77,713,398 of $.0001 par value at September 30, 2010 and December 31, 2009		7,815		7,771
Additional paid-in capital		50,802,147		51,187,754
Accumulated deficit		(49,795,760)		(50,087,293)
TOTAL STOCKHOLDERS EQUITY		1,014,202		1,108,232
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	5,975,995	$	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 September 30, 2010	Three months ended September 30, 2009	Nine months ended September 30, 2010	Nine months ended September 30, 2009
Revenues				
Services	$ 112,090	$ 88,479	$ 316,478	$ 303,983
License fees and other	434,286	435,872	2,639,124	1,039,247
	546,376	524,351	2,955,602	1,343,230
Costs and other expenses				
Cost of services	30,203	15,499	80,391	48,208
Cost of license fees and other	175,967	179,286	339,720	352,088
	206,170	194,785	420,111	400,296
Gross Profit	340,206	329,566	2,535,491	942,934
Operating Expenses				
Selling, general and administrative	817,348	749,771	2,414,810	2,474,986
Research, development and engineering	265,682	245,318	825,607	719,095
	1,083,030	995,089	3,240,417	3,194,081
Operating loss	(742,824)	(665,523)	(704,926)	(2,251,147)
Other income (expenses)				
Derivative and warrant fair value adjustments	(44,768)	(102,193)	932,520	(157,170)
Interest income	61,343	405	182,295	405
Interest expense	(205,448)		(532,531)	
Other		(3,774)		(7,148)
	(188,873)	(105,562)	582,284	(163,913)
Loss from continuing operations	(931,697)	(771,085)	(122,642)	(2,415,060)
Income (loss) from discontinued operations	(12,093)	701,674	414,176	2,707,468
Net income (loss)	$ (943,790)	$ (69,411)	$ 291,534	$ 292,408
Basic and Diluted Earnings per Common Share (See Note 5):				
Loss from continuing operations	$ (0.01)	$ (0.01)	$ (0.01)	$ (0.05)
Income (loss) from discontinued operations	0.00	0.01	0.01	0.04
Net income (loss)	$ (0.01)	$ 0.00	$ 0.00	$ (0.01)
Weighted Average Shares Outstanding:				
Basic and Diluted	78,016,082	73,521,550	77,815,401	71,115,231

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)

	Nine Months Ended September 30, 2010	2009
CASH FLOW FROM OPERATING ACTIVITIES:		
Net income	$ 291,534	$ 292,408
Less:		
Income from discontinued operations	414,176	2,707,468
Income (loss) from continuing operations	(122,642)	(2,415,060)
Adjustments to reconcile net income (loss) to cash used in operating activities:		
Derivative and warrant fair value adjustments	(932,520)	157,170
Depreciation	16,905	17,875
Amortization		
Intangible assets	8,938	18,540
Discount on convertible debt related to derivatives	532,531	33,701
Share-based compensation	38,597	69,419
Change in assets and liabilities:		
Accounts receivable trade	(61,183)	(112,487)
Inventory	1,453	(9,118)
Prepaid expenses and other	(5,414)	(1,284)
Accounts payable	(86,224)	163,999
Accrued liabilities	(99,519)	185,355
Deferred revenue	132,752	(466,656)
Net cash used for continuing operations	(576,326)	(2,358,546)
Net provided by discontinued operations	415,819	1,720,306
Net cash used for operating activities	(160,507)	(638,240)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(9,900)	(25,085)
Deposits		(899)
Transfer of funds from restricted cash	40,500	
Net cash provided by (used for) continuing operations	30,600	(25,984)
Net cash used for discontinued operations		(24,423)
Net cash provided by (used for) investing activities	30,600	(50,407)
CASH FLOW FROM FINANCING ACTIVITIES:		
Issuance of short-term obligations		1,000,000
Repayment of long term obligations		(1,082,460)
Dividends		(37,207)
Net cash provided by (used for) financing activities		(119,667)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(129,907)	(808,314)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	792,426	1,712,912
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 662,519	$ 904,598

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

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	Nine Months Ended September 30, 2010	2009
Noncash Investing and Financing Activities:		
Issuance of Debt in exchange of discounted Series B redeemable preferred Stock	$	$ 398,387
Discount on Series B redeemable preferred Stock		130,153
Issuance of Debt in exchange of discounted Series C redeemable preferred Stock		1,810,495
Discount on Series C redeemable preferred Stock		591,487
Issuance of common stock through conversion of principal, interest and dividends outstanding on preferred stock		767,916
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.

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BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2010 (Unaudited)

1. BASIS OF PRESENTATION

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

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

Recently Issued Accounting Pronouncements

In April 2010, the FASB issued Accounting Standards Update 2010-17 (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. Early adoption is permitted. If a vendor elects early adoption and the period of adoption is not the beginning of the entity s fiscal year, the entity should apply the amendments retrospectively from the beginning of the year of adoption. The Company does not expect the provisions of ASU 2010-17 to have a material effect on its financial position or results of operations.

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 September 30, 2010, we had an accumulated deficit of approximately $50 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-

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

3. DISCONTINUED OPERATIONS

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

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

As consideration for the Asset Sale, Buyer paid the Company an aggregate purchase price of approximately $11.3 million. Of that amount, approximately $7.0 million was paid in cash at the closing of the Asset Sale, and approximately $300,000 was paid pursuant to the working capital adjustment provided for in the Purchase Agreement. Buyer also issued a promissory note (the Note) in the original principal amount of $4.0 million in favor of the Company. The Note is to be paid in three equal annual installments beginning on December 8, 2010 and bears 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 nine month period ended September 30, 2010, the Company recorded income of approximately $483,000 from a contract delivered under our arrangement with Buyer which was reduced by cost of sales and expenses for professional fees, resulting in net income from discontinued operations of approximately $414,000. The Company does not expect any additional income from discontinued operations in the future. The Company and Buyer concluded the post-closing purchase price adjustments on August 3, 2010, which resulted in Buyer paying an additional $76,313 to the Company, and whereby Buyer returned approximately $263,000 of accounts receivable in lieu of a cash payment for the same amount. The Company has collected approximately $132,000 and is still pursuing payment for the balance due.

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4. SHARE BASED COMPENSATION

The Company accounts for share based compensation in accordance with the provisions of ASC 718-10, Compensation Stock Compensation, which requires measurement of compensation cost for all stock awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The majority of our share-based compensation arrangements vest over either a three or four year vesting schedule. The Company expenses its share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant. The fair value of stock options is determined using the Black-Scholes valuation model and requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (the expected option term), the estimated volatility of our common stock price over the option s expected term, the risk-free interest rate over the option s expected term, and the Company s expected annual dividend yield. Changes in these subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized as an expense in the consolidated statements of operations. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, are likely to change our valuation assumptions used to value employee stock-based awards granted in future periods. The values derived from using the Black-Scholes model are recognized as expense over the service period, net of estimated forfeitures (the number of individuals that will ultimately not complete their vesting requirements). The estimation of stock awards that will ultimately vest requires significant judgment. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

The compensation expense recognized under ASC 718 increased the Company s loss from continuing operations by $12,850 and $9,651, and $38,597 and $69,419 for the three and nine months ended September 30, 2010 and 2009, respectively, with no effect per share (basic and diluted).

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

		Three Months Ended September 30, 2010		**Three Months Ended September 30, 2009**
Cost of services	$		$	
Selling, general and administrative		1,468		2,526
Research, development and engineering		11,382		7,125
	$	12,850	$	9,651

		Nine Months Ended September 30, 2010		**Nine Months Ended September 30, 2009**
Cost of services	$		$	
Selling, general and administrative		12,278		51,427
Research, development and engineering		26,319		17,992
	$	38,597	$	69,419

Valuation Assumptions for Stock Options

For the three months ended September 30, 2010 and 2009, 100,000 and 0 stock options were granted, respectively. For the nine months ended September 30, 2010 and 2009, 510,000 and 790,000 stock options were granted, respectively. The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended September 30, 2010	2009
Risk free interest rate	1.63%	N/A
Expected life of options (in years)	4.5	N/A
Expected dividends	0%	N/A
Volatility of stock price	114%	N/A

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	Nine Months Ended September 30, 2010	2009
Risk free interest rate	2.1-2.22%	1.83-1.85%
Expected life of options (in years)	4.30	4.5
Expected dividends	0%	0%
Volatility of stock price	115%	87%

The stock volatility for each grant is determined based on the review of the experience of the weighted average of historical daily price changes of the Company s common stock over the expected option term. The expected term was determined using the simplified method for estimating expected option life, which qualify as plain-vanilla options; and the risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

EQUITY COMPENSATION PLAN INFORMATION

1996 Stock Option Plan

During 1996, the Board of Directors and stockholders of the Company adopted the 1996 Stock Option Plan (the 1996 Plan). Under the 1996 Plan, 750,000 shares of common stock 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 vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined in the 1996 Plan, all options outstanding vest immediately. The 1996 Plan expired in May 2005.

1999 Stock Option Plan

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

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, 4,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of stock options granted may not exceed ten years. Options issued under the 2004

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

Non-Plan Stock Options

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

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Stock Option Activity

The following table summarizes stock option activity for the nine months ended September 30, 2010:

	Number of Options					Weighted average exercise price	Weighted average remaining life (in years)	Aggregate intrinsic value
	1996 Plan	1999 Plan	2004 Plan	Non Plan	Total			
Outstanding, as of December 31, 2009	45,000	500,000	2,073,189	1,329,841	3,948,030	$ 0.24		
Granted			510,000		510,000	0.40		
Exercised								
Forfeited	(45,000)				(45,000)	0.47		
Expired			(2,500)		(2,500)	0.67		
Outstanding, as of September 30, 2010		**500,000**	**2,580,689**	**1,329,841**	**4,410,530**	**0.25**	**4.02**	**$ 98,806**
Vested or expected to vest at September 30, 2010					**4,250,224**	**0.25**	**3.90**	**$ 97,076**
Exercisable at September 30, 2010					**3,759,862**	**0.24**	**3.57**	**$ 87,255**

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

	Options Outstanding			Options Exercisable	
Range of exercise prices	Number of shares	Weighted average exercise price	Weighted average remaining life (in years)	Number exercisable	Weighted average exercise price
$ 0.07-0.21	1,696,272	$ 0.12	5.17	1,455,604	$ 0.11
0.22-0.40	2,299,258	0.30	2.92	2,229,258	0.30
0.41-0.68	340,000	0.46	6.28		
0.69-0.94	75,000	0.94	1.09	75,000	0.94
$ 0.07-0.94	4,410,530			3,759,862	

The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company s closing stock price of $0.18 as of September 30, 2010, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of September 30, 2010 was 1,425,604.

The weighted average fair value of options granted during the three months ended September 30, 2010 was $0.133 per share, and during the nine months ended September 30, 2010 and September 30, 2009 was $0.188 and $0.087 per share, respectively.

As of September 30, 2010, future compensation cost related to nonvested stock options is $83,481 and will be recognized over an estimated weighted average period of approximately 1.39 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 give effect to dilutive convertible securities, options, warrants, preferred stock and other potential common stock outstanding during the period, only in periods in which such effect is dilutive.

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The reconciliation of the numerators of the basic and diluted EPS calculation was as follows for both of the following three and nine month periods ended September 30:

	Three Months ended September 30,		Nine Months ended September 30,	
	2010	2009	2010	2009
Basic Numerator:				
Loss from continuing operations	$ (931,697)	$ (771,085)	$ (122,642)	$ (2,415,060)
Convertible preferred stock dividends and accretion	(162,263)	(244,249)	(481,497)	(971,502)
Loss available to common stockholders (basic EPS)	$ (1,093,960)	$ (1,015,334)	$ (604,139)	$ (3,386,562)
Basic Denominator	78,016,082	73,521,550	77,815,401	71,115,231
Per Share Amount	$ (0.01)	$ (0.01)	$ (0.01)	$ (0.05)

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 September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Preferred Stock	10,185,667	23,533,567	10,185,667	23,533,567
Convertible Debt	2,366,260		2,366,260	
Stock Options	557,272	1,371,272	674,641	1,371,272
Potentially dilutive securities	13,109,199	24,904,839	13,226,568	24,904,839

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 September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Stock options	3,039,258	5,404,169	2,844,258	5,458,169
Warrants	15,369,948	3,775,791	15,369,948	3,775,791
Total	18,409,206	9,179,960	18,314,206	9,233,960

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6. NOTE RECEIVABLE

Notes receivable consisted of the following:

		September 30, 2010 (Unaudited)		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 also issued a promissory note (the Note) in the original principal amount of $4.0 million in favor of the Company. The Note is to be paid in three equal annual installments beginning on the first anniversary of the closing and will bear interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding. The Note is guaranteed by SilkRoad, a private investment firm and a principal owner of Buyer, and is secured by all of the intellectual property assets that were sold to Buyer.

7. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consisted of the following:

		September 30, 2010 (Unaudited)		December 31, 2009
Equipment	$	245,848	$	235,948
Furniture and fixtures		99,199		99,199
Software		28,624		28,624
Leasehold improvements		39,975		39,975
		413,646		403,746
Less accumulated depreciation and amortization		(381,408)		(364,503)
Total	$	32,238	$	39,243

8. OTHER INTANGIBLE ASSETS

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

	September 30, 2010 (Unaudited)			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	(65,927)	221,321	287,248	(56,989)	230,259
Total	$ 287,248	$ (65,927)	$ 221,321	$ 287,248	$ (56,989)	$ 230,259

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Aggregate amortization expense for the three months ended September 30, 2010 and 2009, was $2,979 and $2,946 respectively, and was $8,938 and $8,528 for the nine months ended September 30, 2010 and 2009 respectively.

9. RESTRICTED CASH

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

10. NOTES PAYABLE, CONVERTIBLE DEBT FINANCING / WARRANTS

Effective as of July 2, 2009, the Company entered into a Settlement and Mutual Release Agreement (the Settlement Agreement) with Longview Special Finance, Inc. and Longview Fund, L.P. (collectively, the Longview Entities) in order to resolve all matters relating to the litigation initiated by the Longview Entities, in which they were seeking $2,886,563 in damages and an unspecified amount of interest and attorney s fees from the Company as a result of the Company s alleged improper failure to redeem their outstanding shares of the Company s Convertible Preferred Stock (collectively, the Shares) in accordance with the terms and conditions of such preferred stock. Pursuant to the Settlement Agreement, without admission of any liability or fault, the parties agreed to a payment schedule under which the Company was required to pay a total cash settlement amount of $2,164,922, fifty percent (50%) of which was paid on July 7, 2009. The remaining portion of the settlement amount at interest rate of seventeen percent (17%) per annum was required to be paid in full on or before October 30, 2009. In return, the Longview Entities agreed to a full and complete release of the Company from all claims that were or could have been alleged in the lawsuit and agreed to relinquish all of the Shares upon receiving final payment of the settlement amount. From October 30, 2009 until November 12, 2009, interest on the remaining portion of the settlement amount accrued at twenty percent (20%) per annum. On November 12, 2009, the Company paid in full the entire outstanding portion of the settlement amount, together with all accrued and unpaid interest, and satisfied all of its obligations to the Longview Entities under the Settlement Agreement.

On July 7, 2009, the Company issued an unsecured promissory note (the Note) in the aggregate principal amount of $1,000,000 to the Shaar Fund, Ltd (Shaar). The Note had an interest rate at eight percent (8%) per annum and was originally due and payable on November 4, 2009. Shaar extended the due date of the Note to the earlier to occur of (i) the fifth business day after the closing of the Asset Sale and (ii) January 31, 2010 pursuant to a Note Amendment and Extension Agreement dated as of November 3, 2009 between the Company and Shaar. Shaar had also made a bridge loan to the Company in the principal amount of $750,000, evidenced by the Company s unsecured Six Percent (6%) Promissory Note dated as of November 12, 2009.

Shaar and the Company also entered into a Securities Exchange Agreement dated as of November 12, 2009 (the Exchange Agreement) as the Company had not paid the dividends that had accrued on its Series A Convertible Preferred Stock (the Series A Preferred Stock). Pursuant to the Exchange Agreement, the Company and the holders of the outstanding shares of the Series A Preferred Stock, such holders being Shaar (27,932 shares) and Thomas J. Colatosti (2,625 shares), agreed to the following:

(a) to exchange their shares of Series A Preferred Stock for an equal number of shares of the Company s Series D Convertible Preferred Stock (the Series D Preferred Stock) and

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(b) to issue Seven Percent (7%) Convertible Promissory Notes (the Convertible Notes) and Warrants to purchase up to an aggregate of 5,000,000 shares of the Company s Common Stock, including up to 4,750,000 shares to Shaar and up to 250,000 shares to Mr. Colatosti, at an exercise price of $0.30 per share, for the payment of all dividends accrued and unpaid on their shares of Series A Preferred Stock. See below for a discussion of the accounting treatment of the warrants.

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

On July 27, 2010, one of the Noteholders converted $27,615 of interest and $28,079 of principal into 442,015 shares of common stock, reducing the principal balance to $709,878 One of the Noteholders is Thomas J. Colatosti, the Company s Chairman of the Board. At September 30, 2010, the Company owed him $68,360 in principal and interest.

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

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

As of September 30, 2010, the derivatives were valued at $62,079. Conversion related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 0%; annual volatility of 74%; and risk free annual interest rate of 0.22% as well as probability analysis related to trading volume restrictions.

The initial fair values of the warrants and derivatives were recorded as discounts to the Convertible Notes and are being amortized to interest expense over the expected term of the debt, using the effective interest method. At September 30, 2010, the unamortized discount on the Convertible Notes was $166,118.

Convertible note financing and warrants consisted of the following:

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	September 30, 2010 (Unaudited)	December 31, 2009
Current Portion		
2005		
FMV of warrants	**$**	**$** 47,773
2006		
FMV of warrants	4,239	
2009		
Convertible promissory notes	709,878	737,957
Discount	(166,118)	(659,138)
FMV of embedded derivatives	62,079	344,891
Total	$ 610,078	$ 471,483
Long-Term Portion		
2006		
FMV of warrants		63,901
Total	$	$ 63,901

2005 and 2006 Warrants

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

	September 30, 2010 (Unaudited)	December 31, 2009
Dividend Yield	0%	0%
Annual volatility	116%	107-156%
Risk-free interest rate	0.16%	0.20-0.47%

2009 Convertible Promissory Notes

The account balance shown represents the fair market value of convertible promissory notes issued in 2009. The fair market value of the embedded derivatives attached to the notes are classified as liabilities and were valued using the Binomial Option model with the following assumptions:

	September 30, 2010 (Unaudited)	December 31, 2009
Dividend Yield	0%	0%
Annual volatility	119%	148%
Risk-free interest rate	0.16%	0.47%

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11. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

		September 30, 2010 (Unaudited)		December 31, 2009
Compensation	$	83,224	$	92,860
Compensated absences		155,552		143,387
Dividends Payable		128,644		128,644
Interest Payable		11,633		
Tax payable		5,000		188,000
Other		237,089		155,874
Total	$	621,142	$	708,765

12. REDEEMABLE PREFERRED STOCK

Series D Convertible Preferred Stock

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

As of September 30, 2010, 100,000 Series D Preferred Stock shares were authorized, 30,557 of which were issued and outstanding, at a par value of $0.0001 and a liquidation preference of $100.00 with accumulated dividends in arrears of $163,989, which have been accreted to the principal balance of the Series D Preferred Stock.

The Series D Preferred Stock contains features that are considered embedded derivative financial instruments: Preferred Stock s conversion option: The Preferred Stock is convertible at the Holder s option at any time at the fixed conversion price of $0.30 per share; Semi Annual Dividends Conversion Option: Holders have the option to convert the Preferred Stock s semi-annual dividend payment at any time at the fixed conversion price of $0.30 per share. These features have been bifurcated and recorded on the Company s balance sheet as liabilities, at their fair value. As of September 30, 2010, these embedded derivatives were valued at $21,327. An amount equal to the original value of the derivatives was recorded as a discount to the Series D Preferred Stock. The discount is being accreted to the principal balance of the Series D Preferred Stock, using the effective interest method, over the expected term of the Series D Preferred Stock. At September 30, 2010, the unamortized discount on the Series D Preferred Stock was $107,600.

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13. STOCKHOLDERS EQUITY

Common Stock

The Company is authorized to issue 170,000,000 shares of common stock, $.0001 par value per share, of which 78,155,413 shares were outstanding as of September 30, 2010.

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

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

Warrants

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

	Total Warrants		Weighted average exercise price	Weighted average remaining life (in years)		Aggregate intrinsic value
Outstanding, as of December 31, 2009	16,775,791	$	0.33	4.09		
Granted						
Exercised						
Expired	(1,405,843)	$	0.52			
Outstanding, as of September 30, 2010	15,369,948		0.32	3.68	$	
Vested or expected to vest at September 30, 2010	15,369,948		0.32	3.68		
Exercisable at September 30, 2010	15,369,948		0.32	3.68		

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

Range of exercise prices	Warrants outstanding and Exercisable Number of warrants	Weighted average remaining life (in years)
$ 0.30	14,836,615	3.78
0.75	533,333	0.86
	15,369,948	

14. SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of Biometric products. Prior to the sale of the Law Enforcement division in December 2009, that division had been reported as a separate segment. Geographically, North American sales accounted for approximately 100% and 98% of the Company s total sales for the three months and 95% and 97% for the nine months ended September 30, 2010 and 2009, respectively.

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15. INCOME TAXES

The Company has a valuation allowance against the full amount of its net deferred taxes. The Company currently provides a valuation allowance against deferred taxes when it is more likely than not that some portion, or all of its deferred tax assets will not be realized.

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

16. FAIR VALUE OF FINANCIAL INSTRUMENTS

Cash and cash equivalents, accounts and notes receivable, accounts payable and accrued liabilities, are carried at, or approximate, fair value because of their short-term nature. The Company s derivative financial instruments consisted of embedded derivatives related to the Convertible Notes Payable as well as the Series D Convertible Preferred Stock. These embedded derivatives include certain conversion features on debt principal and accrued interest therein, and also preferred principal and accumulated and unpaid dividends therein. The Company also issued warrants to purchase shares of the Company s Common stock as part of various debt and preferred equity financings. The accounting treatment of the warrants and derivatives requires that the Company record the warrants and derivatives at their relative fair value. The Company utilizes both the Binomial Option Pricing Model and the Black Scholes Option Pricing Model. See Notes 10 and 12 for a further discussion.

17. SUBSEQUENT EVENTS

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

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

CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

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

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

OVERVIEW

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

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

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

In 2007, BIO-key completed a transaction with ZOLL Data Systems, Inc. (ZOLL), a subsidiary of ZOLL Medical Corporation, in which ZOLL acquired substantially all of the assets related to the Company s Fire/EMS Services division. In 2009, BIO-key completed a transaction with InterAct911 Mobile Systems, Inc. (InterAct911), a subsidiary of InterAct911 Corporation, in which InterAct911 acquired substantially all the assets related to the Company s Law Enforcement division. As a result of these transactions, we have organized the Company into one reporting segment: Biometrics. The Company is now focusing on its primary objectives of increasing revenue and managing expenses, by developing leadership technology and applications, and by providing its customers with high quality support and service.

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CRITICAL ACCOUNTING POLICIES

For detailed information on our critical accounting policies and estimates, see our financial statements and notes thereto included in this Report and in our Annual Report on Form 10-K, for the year ended December 31, 2009. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-K filed on March 26, 2010.

RECENT ACCOUNTING PRONOUNCEMENTS

In April 2010, the FASB issued Accounting Standards Update 2010-17 (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. Early adoption is permitted. If a vendor elects early adoption and the period of adoption is not the beginning of the entity s fiscal year, the entity should apply the amendments retrospectively from the beginning of the year of adoption. The Company does not expect the provisions of ASU 2010-17 to have a material effect on its financial position or results of operations.

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.

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RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2010

AS COMPARED TO SEPTEMBER 30, 2009

Consolidated Results of Operations - Percent Trend

	Three Months Ended September 30, 2010	2009
Revenues		
Services	21%	17%
License fees and other	79%	83%
	100%	100%
Costs and other expenses		
Cost of services	6%	3%
Cost of license fees and other	32%	34%
	38%	37%
Gross Profit	62%	63%
Operating expenses		
Selling, general and administrative	150%	143%
Research, development and engineering	48%	47%
	198%	190%
Operating loss	-136%	-127%
Other deductions		
Total other deductions	-35%	-20%
Income (loss) from continuing operations	-171%	-147%
Income (loss) from discontinued operations	-2%	134%
Net loss	-173%	-13%

	Three months ended September 30, 2010	2009	$ Change	% Change
Revenues				
Service	$ 112,090	$ 88,479	$ 23,611	27%
License & other	434,286	435,872	-1,586	0%
Total Revenue	$ 546,376	$ 524,351	$ 22,025	4%
Cost of goods sold				
Service	$ 30,203	$ 15,499	$ 14,704	95%
License & other	175,967	179,286	-3,319	-2%
Total COGS	$ 206,170	$ 194,785	$ 11,385	6%

Revenues

For the three months ended September 30, 2010, service revenue increased 27% from the same period in 2009 as the Company added new maintenance customers over time. License and other revenue for the three months ended September 30, 2010 remained relatively flat. The Company believes that this was largely due to challenging macroeconomic conditions and continued constraints on customers budgets, which resulted in no large new customer orders during the quarter. We did, however, continue to see additional hardware and

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software orders from existing customers.

Costs of goods sold

For the three months ended September 30, 2010, cost of services increased approximately $15,000 from the same period in 2009 due to increased customer support for the expanding customer base.

License and other costs decreased $3,000 for the three months ended September 30, 2010 from the same period in 2009 due to a decrease in costs for temporary outside services required to support specific customer order requirements offset by an increase hardware orders and associated costs.

Selling, general and administrative

	Three months ended September 30, 2010	2009	$ Change	% Change
Selling, general and administrative	$ 817,348	$ 749,771	$ 67,577	9%

Selling, general and administrative expenses increased by 9% for the three months ended September 30, 2010 from the same period in 2009 for professional fees related to a change in independent auditors and marketing expenses for numerous exhibitions attended.

Research, development and engineering

	Three months ended September 30, 2010	2009	$ Change	% Change
Research, development and engineering	$ 265,682	$ 245,318	$ 20,364	8%

For the three months ended September 30, 2010, research, development and engineering costs increased 8% from the same period in 2009 as the Company employed temporary outside services for specific new projects.

Other income and expense

	Three months ended September 30, 2010	2009	$ Change	% Change
Derivative and warrant fair value adjustments	$ (44,768)	$ (102,193)	$ 57,425	-56%
Interest income	61,343	405	60,938	15,046%
Interest expense	(205,448)		(205,448)	N/A
Other expense		(3,774)	3,774	-100%
Total	$ (188,873)	(105,562)	$ (83,311)	79%

For the quarter ended September 30, 2010, the change in derivative and warrant fair value adjustments increased,

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when compared to same quarter 2009, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt in 2005, 2006 and 2009. The fair value of the derivatives will fluctuate based on; our stock price on the valuation date, the debt conversion price, the volatility of our stock price over a period of time, changes in the value of the risk free interest rate, and the time to maturity of the outstanding debt at different points in time. Stock price and volatility are the major drivers behind the movement in the Company s balances.

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

For the quarter ended September 30, 2010, the interest expense was attributable to the non-cash amortization of the discount.

NINE MONTHS ENDED SEPTEMBER 30, 2010 AS COMPARED TO SEPTEMBER 30, 2009

Consolidated Results of Operations - Percent Trend

	Nine Months Ended September 30, 2010	2009
Revenues		
Services	11%	23%
License fees and other	89%	77%
	100%	100%
Costs and other expenses		
Cost of services	3%	4%
Cost of license fees and other	11%	26%
	14%	30%
Gross Profit	86%	70%
Operating expenses		
Selling, general and administrative	82%	184%
Research, development and engineering	28%	54%
	110%	238%
Operating loss	-24%	-168%
Other deductions		
Total other deductions	20%	-12%
Loss from continuing operations	-4%	-180%
Income from discontinued operations	14%	202%
Net Income	10%	22%

	Nine months ended September 30, 2010	2009	$ Change	% Change
Revenues				
Service	316,478	303,983	12,495	4%

License & other		2,639,124		1,039,247		1,599,877	154%
Total Revenue	$	2,955,602	$	1,343,230	$	1,612,372	120%
Cost of goods sold							
Service		80,391		48,208		32,183	67%
License & other		339,720		352,088		(12,368)	-4%
Total COGS	$	420,111	$	400,296	$	19,815	5%

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Revenues

Service revenue for the nine months ended September 30, 2009 increased 4% as the Company increased maintenance customer base compared to the prior year s corresponding period, offset by fewer customized software service orders. License and other revenue for the nine months ended September 30, 2010 increased by 154% due to several large orders from new customers in the healthcare industry and additional orders from current customers.

Costs of goods sold

For the nine months ended September 30, 2010, cost of services increased approximately $32,000 from the same period in 2009 due to increased customer support for the expanding customer base. License and other costs decreased $12,000 for the nine months ended September 30, 2010 from the same period in 2009 due to a decrease in the specific customer requirements for third party software, offset by an increase in hardware orders.

Selling, general and administrative

	Nine months ended September 30, 2010	Nine months ended September 30, 2009	$ Change	% Change
Selling, general and administrative	$ 2,414,810	$ 2,474,986	$ (60,176)	-2%

Selling, general and administrative costs for the nine months ended September 30, 2010 decreased 2% from the same period in 2009. The nine months ended September 30, 2009 included $39,000 more than the same period in 2010 in non-cash compensation charges in accordance with the provisions of ASC 718-10. Reduction in legal and professional services expenses were also significant contributors to the decrease, offset by increased commission, referral fee expenses and fees related to the change in independent auditors.

Research, development and engineering

	Nine months ended September 30, 2010	Nine months ended September 30, 2009	$ Change	% Change
Research, development and engineering	$ 825,607	$ 719,095	$ 106,512	15%

For the nine months ended September 30, 2010, research, development and engineering costs increased 15% from the nine months ended September 30, 2009 related to temporary outside services expenses for specific new projects.

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Other income and expense

	Nine months ended September 30, 2010	2009	$ Change	% Change
Derivative and warrant fair value adjustments	$ 932,520	$ (157,170)	$ 1,089,690	-693%
Interest income	182,295	405	181,890	44,911%
Interest expense	(532,531)		(532,531)	N/A
Other expense		(7,148)	7,148	-100%
Total	$ 582,284	$ (163,913)	$ 746,197	-455%

For the nine months ended September, 2010, the change in derivative and warrant fair value adjustments increased, when compared to same period 2009, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt in 2005, 2006 and 2009. The fair value of the derivatives will fluctuate based on; our stock price on the valuation date, the debt conversion price, the volatility of our stock price over a period of time, changes in the value of the risk free interest rate, and the time to maturity of the outstanding debt at different points in time. Stock price and volatility are the major drivers behind the movement in the Company s balances.

For the nine months ended September 30, 2010, the interest income was attributable to the Note Receivable.

For the nine months ended September 30, 2010, the interest expense was attributable to the non-cash amortization of the discount, and interest payable on the convertible promissory note.

LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended September 30, 2010, net cash used in continuing operations was approximately $576,000. The cash used for continuing operations was primarily due to the following items:

- Positive cash flow due to an increase in deferred revenue of approximately $133,000, offset by an increase in accounts receivable of approximately $61,000; and

- Negative cash flows from a decrease in accounts payable and a decrease accrued liabilities for a total of approximately $174,000.

The following non-cash items reflected in the Company s statement of operations are used to reconcile the net income to the net cash used in operating activities during the nine months ended September 30, 2010:

- The Company issued convertible notes in 2005 and 2006 and preferred stock in 2009, all of which contained embedded derivatives, and associated warrants. During the nine months ended September 30, 2010, the Company realized gains of approximately $933,000 related to the decrease in value of the derivatives and associated warrants. The decrease in value is driven mainly by the decrease in value of the underlying BIO-key stock.

- The Company recorded the amount equal to the original value of the derivatives as a discount to the preferred stock which is being accreted to the principal balance. The Company recorded approximately $533,000 for discount charges during the nine months ended September 30, 2010.

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- The Company recorded approximately $39,000 of charges during the nine months ended September 30, 2010 for the expense of issuing options to employees for services.

Working capital at September 30, 2010 was approximately $1,203,000, as compared to approximately $868,000 at December 31, 2009, the improvement of which was driven mainly by the increase in accounts receivable and the decrease in redeemable preferred stock derivative as a result of the decrease in our stock price.

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

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

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

Liquidity outlook

At September 30, 2010, our total of cash and cash equivalents was $662,519, as compared to $792,426 at December 31, 2009.

As discussed above, the Company has financed itself in the past through access to the capital markets by issuing convertible debt securities, convertible preferred stock and common stock. We currently require approximately $360,000 per month to conduct our operations. During the first nine months of the 2010, we generated approximately $2,956,000 of revenue. While the Company expects to increase revenue through the remainder of 2010, there can be no assurance that we will achieve that goal.

The Company s outstanding shares of Series D Convertible Preferred Stock are redeemable in cash by the holders of such shares on December 31, 2010. This obligation also continues to accrue dividends. While we anticipate receiving the first payment of $1,334,00 on the Note Receivable (see note 6) by December 9, 2010, unless we are able to generate additional net income before December 31,2010, we will have to plan for alternative payment options. These payment options are currently being discussed between Management and the holders of the Series D Convertible Preferred Stock.

If we are unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we will need to obtain additional financing through the issuance of debt or equity securities, or to restructure our financial position, potentially through similar transactions to those consummated during 2006, 2007 and 2009.

Due to several factors, including our history of losses and limited revenue, our independent auditors have included an explanatory paragraph in opinions they have previously issued related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. In addition, the ongoing financial crisis in the global capital markets and the current negative global economic trends have had an adverse impact on market participants including, among other things, volatility in security prices, diminished liquidity, and limited access to financing. These events could, therefore, affect our efforts to commercialize our technology and to obtain adequate financing. In particular, these conditions could impact the ability and willingness of our current and prospective customers to make investments in our technology and pay their obligations to us. To the extent that we require such additional financing, no assurance can be given that any form of additional financing will be available on terms acceptable to us, that adequate financing will be obtained to meet our needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or we fail to continue to generate meaningful revenue,

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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 and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2010. 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. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2010, our Chief Executive Officer and Chief Financial Officer 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, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

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

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SIGNATURES

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

	BIO-Key International, Inc.
Dated: November 12, 2010	/s/ Michael W. DePasquale Michael W. DePasquale Chief Executive Officer
Dated: November 12, 2010	/s/ Cecilia Welch Cecilia Welch Chief Financial Officer

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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

(1) Filed herewith