BIO KEY INTERNATIONAL INC
Form 10QSB
May 22, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended March 31, 2006

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 Small Business Issuer 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)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

APPLICABLE ONLY TO ISSUERS INVOLVED IN

BANKRUPTCY PROCEEDINGS DURING THE

PRECEDING FIVE YEARS

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

Yes o No o

APPLICABLE ONLY TO CORPORATE ISSUERS

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

Yes o No x

State the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date : There were 48,447,762 issued and outstanding shares of the registrant s common stock, par value $.0001 per share, as of May 22, 2006.

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

BIO-KEY INTERNATIONAL, INC.

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	March 31, 2006 (Unaudited)	December 31, 2005 (Unaudited)
ASSETS:		
Cash and cash equivalents	$ 1,594,641	$ 1,422,827
Receivables		
Billed, less allowance for doubtful receivables of $179,999 and $160,000, respectively	3,188,486	1,635,371
Unbilled	26,806	201,942
Costs and earnings in excess of billings on uncompleted contracts	3,173,147	4,321,392
Inventory	10,494	8,760
Prepaid expenses	139,705	137,000
Total current assets	8,133,279	7,727,292
Equipment and leashold improvements, net	496,944	548,267
Costs and earnings in excess of billings on uncompleted contracts		
Deposits	1,362,902	1,828,560
Intangible assets less accumulated amortization	3,095,927	3,311,823
Deferred financing costs	1,526,315	1,552,338
Goodwill	11,389,653	11,389,654
Total non-current assets	17,871,741	18,630,642
TOTAL ASSETS	$ 26,005,020	$ 26,357,934
LIABILITIES:		
Current maturities of long-term obligations and related obligations, net of discount	$ 6,288,608	$ 6,584,437
Accounts payable	1,151,611	833,608
Billings in excess of costs and earnings on uncompleted contracts	42,554	32,385
Accrued liabilities	6,021,970	5,520,515
Deferred rent	457,046	443,603
Deferred revenue	4,264,645	3,264,283
Total current liabilities	18,226,434	16,678,831
Warrants	1,618,341	1,483,511
Mandatorily redeemable preferred stock	1,015,205	
Deferred rent	748,424	867,850
Deferred revenue	1,209,108	1,163,738
Total non-current liabilities	4,591,078	3,515,099
TOTAL LIABILITIES	22,817,512	20,193,930
Commitments and contingencies		
STOCKHOLDERS EQUITY (DEFICIT):		
Preferred stock authorized, 5,000,000 shares (liquidation preference of $100 per share) Series A 7% Convertible; issued and outstanding 35,557 Shares of $.0001 par value	3	4
Common stock authorized, 170,000,000 shares; issued and outstanding; 48,203,134 and 44,344,351 shares of $.0001 par value in 2006 and 2005, respectively	4,803	4,632
Additional paid-in capital	49,220,571	48,921,316
Accumulated deficit	(46,037,869)	(42,761,948)
TOTAL STOCKHOLDERS EQUITY (DEFICIT)	3,187,508	6,164,004
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)	$ 26,005,020	$ 26,357,934

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

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

	Three Months Ended March 31, 2006	2005 (Restated)
Revenues		
Services	$ 2,246,911	$ 3,059,854
License fees and other	902,280	879,737
	3,149,191	3,939,591
Costs and other expenses		
Services	673,503	835,565
Cost of license fees and other	81,484	327,857
Selling, general and administrative	2,576,821	2,846,623
Research, development and engineering	1,654,638	2,075,070
	4,986,446	6,085,115
Operating loss	(1,837,255)	(2,145,524)
Other income (deductions)		
Interest income		26,062
Interest expense	(2,666,609)	(834,916)
Derivative and warrant fair market value adjustments	2,197,233	3,576,881
Loss on extinguishment of debt	(813,432)	
Dividends on mandatorily redeemable preferred stock	(15,205)	
Other income (expense)	(15,176)	(20,000)
Total other income (deductions)	(1,313,189)	2,748,027
NET INCOME (LOSS)	$ (3,150,444)	$ 602,503
Earnings (Loss) Per Share:		
Basic	$ (0.07)	$ 0.01
Diluted	$ (0.07)	$ (0.03)
Weighted Average Shares Outstanding:		
Basic	46,738,170	42,662,253
Diluted	46,738,170	48,754,992

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

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

	Three Months Ended March 31, 2006	2005 Restated
CASH FLOW FROM OPERATING ACTIVITIES:		
Net Income (Loss)	$ (3,150,444)	$ 602,503
Adjustments to reconcile net loss to cash used in operating activities:		
Derivative and warrant fair value adjustments	(2,197,233)	(3,576,881)
Loss on extinguishment of debt	813,432	
Depreciation	65,044	58,590
Amortization		
Intangible assets	215,880	222,993
Financing fees	603,005	
Discounts on convertible debt related to warrants and beneficial conversion features	1,220,202	463,202
Allowance for doubtful receivables	19,998	19,790
Deferred rent	(105,986)	(94,057)
Dividends on mandatorily redeemable preferred stock	15,205	
Options and warrants issued for services and other	120,567	
Loss on sale of investment		20,000
Change in assets and liabilities:		
Accounts receivable trade	(1,504,834)	(655,593)
Costs and earnings in excess of billings on uncompleted contracts	1,255,102	92,235
Inventory	(1,734)	
Prepaid expenses and other	(2,705)	(18,195)
Deposits	465,657	502,943
Accounts payable	318,003	(238,721)
Billings in excess of costs and earnings on uncompleted contracts	10,169	1,054,043
Accrued liabilities	137,554	776,864
Deferred revenue	1,045,733	350,922
Net cash used in operating activities	(657,385)	(419,362)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(13,720)	(73,348)
Expenditures for Patents	(9,983)	
Proceeds from sale of marketable debt securities		980,000
Proceeds from sale of trademark		50,000
Net cash provided by (used in) investing activities	(23,703)	956,652
CASH FLOW FROM FINANCING ACTIVITIES:		
Net advance from (to) stockholders		(12,753)
Issuance of long-term obligations	1,000,000	
Repayment of long term obligations	(82,314)	(738,346)
Issuance of common stock in conversion	15	
Exercise of warrants		528,164
Expenditures for financing costs	(64,799)	
Net refund of offering costs		100,000
Net cash provided by (used in) financing activities	852,902	(122,935)
NET INCREASE (DECREASE) IN CASH	171,814	414,355
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	1,422,827	956,230
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 1,594,641	$ 1,370,585

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

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BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006 (Unaudited) and December 31, 2005 (Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements include the accounts of BIO-key International, Inc. and its wholly owned subsidiary (collectively, the Company) and are stated in conformity with accounting principles generally accepted in the United States, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). As described further below, however, the financial statements have not been reviewed by an independent registered accounting firm. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted. Significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the financial position and the results of its operations and cash flows for the periods presented. It is suggested that these interim consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company s Annual Report on Form 10-KSB for the fiscal year ended December 31, 2005, as amended (the Form 10-KSB). For those items that have been restated pursuant to footnote 15, the applicable footnotes from the Form 10-KSB have been superceded by the footnotes included herewith.

The financial statements presented in the Form 10-KSB had previously been audited by the Company s independent registered accounting firm. As previously described by the Company in its Current Report on Form 8-K filed with the SEC on May 18, 2006, as amended, subsequent to the Company s filing of the Form 10-KSB, it s independent registered accounting firm has withdrawn their opinion dated March 29, 2006 to the December 31, 2005 and 2004 financial statements included in the Form 10-KSB. Additionally, they were unable to complete their review of the March 31, 2006 financials included herewith.

The accompanying financials, which have been restated as per footnote 15, present all adjustments that have been identified to date, however the financials previously issued continue to be reviewed by both the Company s management and the SEC. Based on the findings of these reviews and any further comments, that we may receive from the SEC, additional adjustments maybe required.

Reclassifications

Certain amounts in the 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation. These reclassifications had no effect on the previously reported net loss or stockholders equity (deficit).

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

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

The Company is in need of additional capital. The Company is currently considering various alternatives related to raising additional capital including including new funding from other sources. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained to meet its needs, or that such financing would not be dilutive to existing shareholders.

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which contemplate continuation of the Company as a going concern. The matters described in the preceding paragraphs raise substantial doubt about the Company s ability to continue as a going concern. Recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon the Company s ability to obtain additional financing, meet its financing requirements on a continuing basis, and succeed in its future operations. The accompanying financial statements do not include any adjustments that may result from the uncertainty regarding the Company s ability to continue as a going concern.

3. STOCK BASED COMPENSATION

Effect of Adoption of SFAS 123R, Share-Based Payment

Prior to January 1, 2006, the Company s employee stock compensation plans were accounted for in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations. Under this method, no compensation expense was recognized as long as the exercise price equaled or exceeded the market price of the underlying stock on the date of the grant. The Company elected the disclosure-only alternative permitted under SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), for fixed stock-based awards to employees.

On December 31, 2005, the Company accelerated the vesting of certain of the outstanding options to purchase shares of the Company s common stock with option exercise prices greater than the fair market value of the Company s common stock on such date. The acceleration applies to all such options outstanding as of December 31, 2005 under the Company s 1996 Stock Option Plan, 1999 Stock Option Plan and 2004 Stock Option Plan, except for options held by the Company s executive officers subject to Section 16(b) of the Securities Exchange Act of 1934, as amended, and the members of the Company s Board of Directors. Options to purchase up to 897,614 shares of the Company s common stock, or 14% of the total shares of the Company s common stock subject to outstanding options, with a weighted average exercise price of approximately $1.09 and varying remaining vesting schedules, are subject to this acceleration and become immediately vested and exercisable as of December 31, 2005. The number of shares, exercise prices and other term of the options subject to the acceleration remain unchanged.

As of January 1, 2006, the Company adopted SFAS 123R using the modified prospective method, which requires measurement of compensation cost for all stock awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS 123, as amended by SFAS 148, 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 term), the estimated volatility of our common stock price over the expected term and the number of options that will ultimately not complete their vesting requirements (forfeitures). 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 on the consolidated statements of operations. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, we 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 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. Prior periods have not been restated to incorporate the stock-based compensation charge. The compensation expense recognized in connection with the adoption of SFAS 123R increased the company s net loss by $120,567, with no effect per share. There was no impact on cash flows from operations, investment, or financing in connections with the adoptions of SFAS 123R. As the Company uses the full valuation allowance with respect to deferred taxes, the adoption of SFAS123R had no impact on deferred taxes.

Valuation Assumptions for Stock Options

For the quarter ended March 31, 2006, 1,798,000 stock options were granted. The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended March 31,	
	2006	**2005**
Risk free interest rate	4.53-4.73%	4.00-4.18%
Expected life of options (in years)	4.4	7
Expected dividends	0	0
Volatility of stock price	127%	133%

Expected volatilities are based on historical volatilities of our common stock; the expected life represents the weighted average period of time that options granted are expected to be outstanding giving consideration to vesting schedules and our historical exercise patterns; 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.

Fair Value Disclosures Prior to SFAS 123R Adoption

	Three Months Ended March 31, 2005 (Restated)
Net income (loss):	
As reported	602,503
Fair value-based expense, net of tax	(211,000)
Pro forma	391,503