

BIO KEY INTERNATIONAL INC  
Form 10-Q  
August 10, 2009  
[Table of Contents](#)

## 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 June 30, 2009

or

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-13463

## BIO-KEY INTERNATIONAL, INC.

(Exact Name of Registrant as Specified in Its Charter)

**DELAWARE**  
(State or Other Jurisdiction of  
Incorporation of Organization)

**41-1741861**  
(IRS Employer  
Identification Number)

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

(Address of Principal Executive Offices)

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(732) 359-1100

(Issuer's Telephone Number)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

Number of shares of Common Stock, \$.0001 par value per share, outstanding as of August 7, 2009 were 73,012,744.

Table of Contents

**BIO-KEY INTERNATIONAL, INC.**

**INDEX**

PART I. FINANCIAL INFORMATION

Item 1	Condensed Consolidated Financial Statements	
	<u>Balance sheets as of June 30, 2009 (unaudited) and December 31, 2008</u>	3
	<u>Statements of operations for the three and six months ended June 30, 2009 and 2008 (unaudited)</u>	4
	<u>Statements of cash flows for the six months ended June 30, 2009 and 2008 (unaudited)</u>	5
	<u>Notes to condensed consolidated financial statements</u>	7
<u>Item 2</u>	<u>Management's Discussion and Analysis of Financial Conditions and Results of Operations</u>	24
<u>Item 4</u>	<u>Controls and Procedures</u>	36

PART II. OTHER INFORMATION

<u>Item 1</u>	<u>Legal Proceedings</u>	37
<u>Item 6</u>	<u>Exhibits</u>	37

<u>Signatures</u>		38
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Table of Contents**PART I FINANCIAL INFORMATION****FINANCIAL STATEMENTS BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS**

	June 30, 2009 (Unaudited)	December 31, 2008
<b>ASSETS</b>		
Cash and cash equivalents	\$ 563,559	\$ 1,712,912
Accounts receivable, net of allowance for doubtful accounts of \$82,398 at June 30, 2009 and December 31, 2008	1,170,446	721,022
Costs and earnings in excess of billings on uncompleted contracts		144,551
Inventory	19,977	13,159
Prepaid expenses	89,006	96,109
Total current assets	1,842,988	2,687,753
Equipment and leasehold improvements, net	80,717	92,238
Deposits and other assets	8,711	7,812
Restricted cash	40,500	40,500
Intangible assets less accumulated amortization	310,714	582,701
Goodwill	7,836,986	7,836,986
Total non-current assets	8,277,628	8,560,237
<b>TOTAL ASSETS</b>	<b>\$ 10,120,616</b>	<b>\$ 11,247,990</b>
<b>LIABILITIES</b>		
Accounts payable	\$ 300,632	\$ 280,994
Accrued liabilities	1,182,104	1,301,889
Note payable	286,343	1,516,651
Deferred rent	16,352	6,541
Deferred revenue	3,373,878	3,684,476
Total current liabilities	5,159,309	6,790,551
Warrants	59,667	12,317
Redeemable preferred stock derivatives	8,066	439
Deferred rent	28,774	11,510
Deferred revenue	49,989	8,382
Total non-current liabilities	146,496	32,648
<b>TOTAL LIABILITIES</b>	<b>5,305,805</b>	<b>6,823,199</b>
Commitments and contingencies		
Series B redeemable convertible preferred stock: authorized, 1,000,000 shares (liquidation preference of \$1 per share); issued and outstanding 970,612 shares of \$.0001 par value at June 30, 2009 and December 31, 2008	1,012,322	1,008,224
Series C redeemable convertible preferred stock: authorized, 600,000 shares (liquidation preference of \$10 per share); issued and outstanding 592,032 shares of \$.0001 par value at June 30, 2009 and December 31, 2008	6,599,614	6,498,516
	7,611,936	7,506,740
<b>STOCKHOLDERS DEFICIT:</b>		
Series A convertible preferred stock: authorized, 100,000 shares (liquidation preference of \$100 per share); issued and outstanding 30,557 shares of \$.0001 par value, at June 30, 2009 and December 31, 2008	3	3

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Common stock authorized, 170,000,000 shares; issued and outstanding; 72,650,096 and 67,876,880 of \$.0001 par value at June 30, 2009 and December 31, 2008, respectively	7,265	6,788
Additional paid-in capital	51,614,631	51,692,103
Accumulated deficit	(54,419,024)	(54,780,843)
<b>TOTAL STOCKHOLDERS DEFICIT</b>	<b>(2,797,125)</b>	<b>(3,081,949)</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>	<b>\$ 10,120,616</b>	<b>\$ 11,247,990</b>

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

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

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
<b>Revenues</b>				
Services	\$ 1,889,047	\$ 1,828,345	\$ 3,834,428	\$ 3,545,615
License fees and other	823,675	1,751,608	1,970,280	2,574,756
	2,712,722	3,579,953	5,804,708	6,120,371
<b>Costs and other expenses</b>				
Cost of services	350,517	288,748	656,495	636,333
Cost of license fees and other	100,167	132,430	225,929	226,326
	450,684	421,178	882,424	862,659
Gross Profit	2,262,038	3,158,775	4,922,284	5,257,712
<b>Operating Expenses</b>				
Selling, general and administrative	1,320,761	1,695,306	2,796,986	3,484,398
Research, development and engineering	769,109	1,164,217	1,668,882	2,411,248
	2,089,870	2,859,523	4,465,868	5,895,646
Operating profit (loss)	172,168	299,252	456,416	(637,934)
<b>Other income (expenses)</b>				
Derivative and warrant fair value adjustments	(19,646)	(41,915)	(54,976)	(11,174)
Interest income		399		1,298
Interest expense	(12,752)	(7,884)	(36,246)	(18,007)
Other		(16,142)	(3,375)	(16,142)
	(32,398)	(65,542)	(94,597)	(44,025)
Income (loss) from continuing operations	139,770	233,710	361,819	(681,959)
Income (loss) from discontinued operations		(65,454)		(65,454)
Net income (loss)	\$ 139,770	\$ 168,256	\$ 361,819	\$ (747,413)
<b>Basic and Diluted Earnings per Common Share:</b>				
Income (loss) from continuing operations	\$ 0.00	\$ 0.00	\$ (0.01)	\$ (0.03)
Income (loss) from discontinued operations	0.00	0.00	0.00	0.00
Net income (loss)	\$ 0.00	\$ 0.00	\$ (0.01)	\$ (0.03)
<b>Weighted Average Shares Outstanding:</b>				
Basic	71,291,168	63,180,281	69,892,130	62,483,507
Diluted	71,306,168	63,180,281	70,682,130	62,483,507

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

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

	<b>Six Months Ended June 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>CASH FLOW FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 361,819	\$ (747,413)
Less:		
Income from discontinued operations		65,454
Income (loss) from continuing operations	361,819	(681,959)
<b>Adjustments to reconcile net loss to cash used in operating activities:</b>		
Derivative and warrant fair value adjustments	54,976	11,174
Depreciation	34,893	68,745
Amortization		
Intangible assets	271,987	368,712
Allowance for doubtful receivables		(1,371)
Deferred rent	27,075	(273,225)
Share-based compensation	65,408	332,201
<b>Change in assets and liabilities:</b>		
Accounts receivable trade	(449,423)	680,188
Costs and earnings in excess of billings on uncompleted contracts	144,551	168,100
Inventory	(6,818)	(33,439)
Prepaid expenses and other	7,103	39,728
Accounts payable	19,638	1,996,658
Accrued liabilities	(119,785)	(2,125,406)
Note payable	(1,230,308)	
Deferred revenue	(268,991)	(973,442)
Net cash used for continuing operations	(1,087,875)	(423,336)
Net cash used for discontinued operations		(15,454)
Net cash used for operating activities	(1,087,875)	(438,790)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(23,372)	(15,371)
Deposits	(899)	
Transfer of funds from restricted cash		153,094
Proceeds from sale of assets		10,530
Net cash provided by (used for) continuing operations	(24,271)	148,253
Net cash used for discontinued operations		(50,000)
Net cash provided by (used for) investing activities	(24,271)	98,253
<b>CASH FLOW FROM FINANCING ACTIVITIES:</b>		
Dividends	(37,207)	
Net cash used for financing activities	(37,207)	
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(1,149,353)</b>	<b>(340,537)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>1,712,912</b>	<b>964,774</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 563,559</b>	<b>\$ 624,237</b>

Table of Contents

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

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	Six Months Ended June 30,	
	2009	2008
Cash paid for:		
Interest	\$ 36,246	\$
Issuance of common stock through conversion of principal and dividends outstanding on preferred stock	443,707	342,349

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



Table of Contents

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

June 30, 2009 (Unaudited)

1. **BASIS OF PRESENTATION**

The accompanying unaudited interim consolidated financial statements include the accounts of BIO-key International, Inc. and its wholly owned subsidiary (collectively, the Company ) and are stated in conformity with accounting principles generally accepted in the United States, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC ). 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, 2008 was derived from the audited financial statements, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America. These unaudited interim consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2008 (the Form 10-K ) filed on March 11, 2009.

In connection with the preparation of the condensed financial statements and in accordance with the recently issued Statement of Financial Accounting Standards ( SFAS ) No. 165 Subsequent Events ( SFAS 165 ), the Company evaluated subsequent events after the balance sheet date of June 30, 2009 through August 10, 2009.

*Recently Issued Accounting Pronouncements*

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* (SFAS No. 160) which establishes accounting and reporting standards for the non-controlling interest in a subsidiary for the deconsolidation of a subsidiary. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim statements within those fiscal years. The Company does not currently have any non-controlling interests.

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In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. (SFAS No.161) which amends and expands the disclosure requirements related to derivative instruments and hedging activities. The Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. The provisions of SFAS 161 are effective for the fiscal year beginning January 1, 2009. The Company will comply with the disclosure requirements of this statement since it utilizes derivative instruments.

In October 2008, the FASB issued Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157, which the Company adopted as of January 1, 2008, in cases where a market is not active. The Company will comply with the clarification to the original application.

In November 2008, the FASB ratified the EITF consensus on Issue No. 08-7, *Accounting for Defensive Intangible Assets* (EITF 08-7). The consensus addresses the accounting for an intangible asset acquired in a business combination or asset acquisition that an entity does not intend to use or intends to hold to prevent others from obtaining access (a defensive intangible asset). Under EITF 08-7, a defensive intangible asset needs to be accounted as a separate unit of accounting and would be assigned a useful life based on the period over which the asset diminishes in value. EITF 08-7 was effective for transactions occurring after

Table of Contents

December 31, 2008. The Company will consider this standard in terms of intangible assets in connection with any future acquisitions.

In February 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (SFAS No. 141(R)-a) which simplifies how entities will be required to account for contingencies arising in business combinations under SFAS 141(R) *Accounting for Business Combinations*. FASB decided to amend the guidance SFAS 141(R) to require assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value, if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would be accounted for in accordance with FASB Statement No. 5 *Accounting for Contingencies* (SFAS 5). The provisions of SFAS No. 141(R)-a are applicable to business combinations consummated after January 1, 2009 for calendar year entities. The adoption of SFAS 141(R)-a will have an impact on the Company's accounting for business combinations in connection with any future acquisitions.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP 115-2). This FSP modifies the requirements for recognizing other-than-temporarily impaired debt securities and changes the existing impairment model for such securities. The FSP also requires additional disclosures for both annual and interim periods with respect to both debt and equity securities. Under the FSP, impairment of debt securities will be considered other-than-temporary if an entity (1) intends to sell the security, (2) more likely than not will be required to sell the security before recovering its cost, or (3) does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell). The FSP further indicates that, depending on which of the above factor(s) causes the impairment to be considered other-than-temporary, (1) the entire shortfall of the security's fair value versus its amortized cost basis or (2) only the credit loss portion would be recognized in earnings while the remaining shortfall (if any) would be recorded in other comprehensive income. FSP 115-2 requires entities to initially apply the provisions of the standard to previously other-than-temporarily impaired debt securities existing as of the date of initial adoption by making a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The cumulative-effect adjustment potentially reclassifies the noncredit portion of a previously other-than-temporarily impaired debt security held as of the date of initial adoption from retained earnings to accumulated other comprehensive income. This FSP is effective April 1, 2009. The adoption of FSP FAS 115-2 and FAS 124-2 did not have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. This FSP essentially expands the disclosure about fair value of financial instruments that were previously required only annually to also be required for interim period reporting. In addition, the FSP requires certain additional disclosures regarding the methods and significant assumptions used to estimate the fair value of financial instruments. These additional disclosures will be required beginning with the quarter ending June 30, 2009. The Company has adopted the requirements of this pronouncement effective this quarter ended June 30, 2009.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165). SFAS 165 sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 will be effective for interim or annual period ending after June 15, 2009 and will be applied prospectively. The Company has adopted the requirements of this pronouncement for this quarter ended June 30, 2009. In connection with the preparation of the condensed financial statements and in accordance with the recently issued SFAS 165, the Company evaluated subsequent events after the balance sheet date of June 30, 2009 through August 10, 2009.

In June 2009, the FASB issued SFAS No. 166 *Accounting for Transfers of Financial Assets* (SFAS 166). Statement 166 is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of*



Table of Contents

Financial Assets and Extinguishments of Liabilities, and will require more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. SFAS 166 enhances information reported to users of financial statements by providing greater transparency about transfers of financial assets and an entity's continuing involvement in transferred financial assets. SFAS 166 will be effective at the start of a reporting entity's first fiscal year beginning after November 15, 2009. Early application is not permitted. We are currently evaluating the impact of adoption of SFAS 166 on the accounting for our convertible notes and related warrant liabilities.

In June 2009, the FASB issued SFAS No. 167 *Amendments to FASB Interpretation No. 46(R)* (SFAS 167). Statement 167 is a revision to FASB Interpretation No. 46 (Revised December 2003), Consolidation of Variable Interest Entities, and changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity's purpose and design and the reporting entity's ability to direct the activities of the other entity that most significantly impact the other entity's economic performance. SFAS 167 will require a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity will be required to disclose how its involvement with a variable interest entity affects the reporting entity's financial statements. SFAS 167 will be effective at the start of a reporting entity's first fiscal year beginning after November 15, 2009. Early application is not permitted. We are currently evaluating the impact, if any, of adoption of SFAS 167 on our financial statements.

In June 2009, the FASB issued SFAS No. 168 *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - A Replacement of FASB Statement No. 162* (SFAS 168). Statement 168 establishes the FASB Accounting Standards Codification™ (Codification) as the single source of authoritative U.S. generally accepted accounting principles (U.S. GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. SFAS 168 and the Codification are effective for financial statements issued for interim and annual periods ending after September 15, 2009. When effective, the Codification will supersede all existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification will become nonauthoritative. Following SFAS 168, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead, the FASB will issue Accounting Standards Updates, which will serve only to: (a) update the Codification; (b) provide background information about the guidance; and (c) provide the bases for conclusions on the change(s) in the Codification. The adoption of SFAS 168 will not have an impact on our consolidated financial statements.

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have incurred significant losses to date, and at June 30, 2009, we had an accumulated deficit of approximately \$54.5 million. While our Law Enforcement business operates in a mature market, the potential for significant growth of the Company as a whole is largely dependent upon market development and market acceptance of our biometric technology.

If the Company is unable to generate revenues as planned, 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



Table of Contents

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, and assumes continuity of operations, realization of assets and the satisfaction of liabilities and commitments in the normal course of business. 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 in existence.

3. DISCONTINUED OPERATIONS

On May 22, 2007, the Company and ZOLL Data Systems, Inc. ( ZOLL ), a subsidiary of ZOLL Medical Corporation, entered into an Asset Purchase Agreement (the Purchase Agreement ), pursuant to which ZOLL acquired substantially all of the assets related to the Company's Fire/EMS Services division (the Fire Segment or Fire ).

At the closing of the sale, the Company received approximately \$1.8 million in cash, which represented the purchase price of \$7 million, less closing adjustments of approximately \$4.3 million, which was paid to the Senior Noteholder (see Note 9), approximately \$450,000, which was paid to the leaseholder of the Company's premises, \$400,000, which was placed in escrow pursuant to the Purchase Agreement, and approximately \$40,000 credited to Zoll on the assumption of certain liabilities.

During the quarter ended September 30, 2007, \$250,000 of the escrow balance was released to ZOLL. The remaining escrow balance was remitted to the Company May 6, 2008. From the remaining balance, \$50,000 was paid as a settlement of a customer claim associated with the discontinued Fire business, and \$15,454 was paid as related professional fees to settle the claim which resulted in the \$65,454 loss .

Prior to the sale, Fire had been reported as a separate segment. The Company sold its Fire operating segment to better focus on its core lines of business. The Fire business has been reported as a discontinued operation in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and all periods presented have been recast accordingly to reflect these operations as discontinued.

Revenues and net income (loss) for the Fire Segment for the three and six month periods ended June 30, 2009 and 2008 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Revenues	\$		\$	
Net income (loss)		(65,454)		(65,454)

4. SHARE BASED COMPENSATION

The Company accounts for share based compensation in accordance with the provisions of SFAS 123R, 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 three or four years. 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



Table of Contents

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

The compensation expense recognized under SFAS 123R increased the Company's loss from continuing operations by \$13,112 and \$65,408 with no effect per share (basic and diluted) for the three months ended June 30, 2009 and 2008 respectively, and \$65,408 and \$332,201 with 0.00 and \$0.01 effect per share (basic and diluted), for the six months ended June 30, 2009 and 2008 respectively.

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

	<b>Three Months Ended June 30, 2009</b>	<b>Three Months Ended June 30, 2008</b>
Cost of services	\$ 676	\$ 2,666
Selling, general and administrative	9,428	47,749
Research, development and engineering	3,008	14,993
	<b>\$ 13,112</b>	<b>\$ 65,408</b>

  

	<b>Six Months Ended June 30, 2009</b>	<b>Six Months Ended June 30, 2008</b>
Cost of services	\$ 3,065	\$ 13,639
Selling, general and administrative	52,428	232,934
Research, development and engineering	9,915	85,628
	<b>\$ 65,408</b>	<b>\$ 332,201</b>

*Valuation Assumptions for Stock Options*

For the three months ended June 30, 2009 and 2008, 15,000 and 564,272 stock options were granted, respectively. For the six months ended June 30, 2009 and 2008, 790,000 and 564,272 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:

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	Three Months Ended June 30,	
	2009	2008
Risk free interest rate	1.85%	2.95-3.72%
Expected life of options (in years)	4.5	4.5
Expected dividends	0%	0%
Volatility of stock price	87%	88%

Table of Contents

	Six Months Ended June 30,	
	2009	2008
Risk free interest rate	1.83-1.85%	2.95-3.72%
Expected life of options (in years)	4.5	4.5
Expected dividends	0%	0%
Volatility of stock price	87%	88%

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

## EQUITY COMPENSATION PLAN INFORMATION

*1996 Stock Option Plan*

During 1996, the Board of Directors and stockholders of the Company adopted the 1996 Stock Option Plan (the 1996 Plan). Under the 1996 Plan, 750,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 100% of fair market value for incentive stock options and 50% for all others. The term of stock options granted may not exceed ten years. Options issued under the 1996 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 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 are not available under the plan. Under the 1999 Plan, 2,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of non-statutory stock options granted may 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, all options outstanding vest immediately. The 1999 Plan expires in August 2009.

*2004 Stock Option Plan*

On October 12, 2004, the Board of Directors of the Company approved the 2004 Stock Option Plan (the 2004 Plan). The 2004 Plan has not yet been presented to stockholders for approval and thus incentive stock options are not available under this plan. Under the terms of 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

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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, certain of the non-plan options outstanding vest immediately.

Table of Contents

*Stock Option Activity*

The following table summarizes stock option activity for the six months ended June 30, 2009:

	<b>1996 Plan</b>	<b>1999 Plan</b>	<b>Number of Options 2004 Plan</b>	<b>Non Plan</b>	<b>Total</b>	<b>Weighted average exercise price</b>	<b>Weighted average remaining life (in years)</b>	<b>Aggregate intrinsic value</b>
<hr/>								