BIO KEY INTERNATIONAL INC
Form 10-Q
August 14, 2012
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 June 30, 2012
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 x 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 August 13, 2012 was 78,155,413.

BIO-KEY INTERNATIONAL, INC.

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PART I -- FINANCIAL INFORMATION

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

	June 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Cash and cash equivalents	$54,031	$43,437
Accounts receivable, net of allowance for doubtful accounts of $590,526 at June 30, 2012 and $397,526 December 31, 2011	256,030	587,346
Due from factor	13,898	-
Inventory	6,527	8,238
Prepaid expenses and other	42,612	58,920
Total current assets	373,098	697,941
Equipment and leasehold improvements, net	36,983	52,870
Deposits and other assets	8,712	8,712
Intangible assets—less accumulated amortization	201,545	207,180
Total non-current assets	247,240	268,762
TOTAL ASSETS	$620,338	$966,703
LIABILITIES		
Accounts payable	$656,395	$687,441
Accrued liabilities	657,945	675,833
Deferred revenue	442,473	527,092
Notes payable	346,428	346,428
Total current liabilities	2,103,241	2,236,794
Deferred revenue	-	1,000
Total non-current liabilities	-	1,000
TOTAL LIABILITIES	2,103,241	2,237,794
Commitments and contingencies		
STOCKHOLDERS’ DEFICIENCY:		
Common stock — authorized, 170,000,000 shares; issued and outstanding; 78,155,413 of $.0001 par value at June 30, 2012 and December 31, 2011	7,815	7,815
Additional paid-in capital	51,050,890	51,012,782
Accumulated deficit	(52,541,608)	(52,291,688)
TOTAL STOCKHOLDERS’ DEFICIENCY	(1,482,903)	(1,271,091)
TOTAL LIABILITIES AND STOCKHOLDERS’ DEFICIENCY	$620,338	$966,703

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

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

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Revenues				
Services	$167,313	$150,627	$563,168	$308,972
License fees and other	365,400	833,526	1,379,972	2,080,294
	532,713	984,153	1,943,140	2,389,266
Costs and other expenses				
Cost of services	23,665	31,329	147,682	65,815
Cost of license fees and other	118,120	261,247	175,533	341,633
	141,785	292,576	323,215	407,448
Gross Profit	390,928	691,577	1,619,925	1,981,818
Operating Expenses				
Selling, general and administrative	739,289	638,260	1,344,174	1,347,964
Research, development and engineering	258,931	287,356	513,417	583,906
	998,220	925,616	1,857,591	1,931,870
Operating (loss) profit	(607,292)	(234,039)	(237,666)	49,948
Other income (expenses)				
Interest income	2	30,898	4	95,030
Interest expense	(6,129)	(291,083)	(12,259)	(399,132)
Net discounts of notes payable and note receivable	-	(100,000)	-	(100,000)
	(6,127)	(360,185)	(12,255)	(404,102)
Net loss	$(613,419)	$(594,224)	$(249,921)	$(354,154)
Basic and Diluted Loss per Common Share	$(0.01)	$(0.01)	$0.00	$0.00
Weighted Average Shares Outstanding:				
Basic and diluted	78,155,413	78,155,413	78,155,413	78,155,413

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

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

	Six Months Ended June 30, 2012	2011
CASH FLOW FROM OPERATING ACTIVITIES:		
Net loss	$(249,921)	$(354,154)
Adjustments to reconcile net loss to cash used in operating activities:		
Allowance for doubtful accounts	193,000	-
Depreciation	15,887	14,764
Amortization		
Intangible assets	5,635	5,635
Discount on secured debt	-	307,932
Net discounts of notes payable and note receivable	-	100,000
Share-based compensation	38,109	36,329
Change in assets and liabilities:		
Accounts receivable trade	138,316	(1,384,296)
Factor	(13,898)	-
Inventory	1,710	3,545
Prepaid expenses and other	16,309	100,689
Accounts payable	(31,046)	317,233
Accrued liabilities	(17,888)	108,752
Deferred revenue	(85,619)	211,652
Net cash provided by (used for) operating activities	10,594	(531,919)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	-	(52,804)
Net cash used for investing activities	-	(52,804)
CASH FLOW FROM FINANCING ACTIVITIES:		
Repayment of notes payable	-	(3,612,135)
Proceeds from payment of note receivable	-	3,350,000
Dividends paid	-	(125,209)
Net cash used for financing activities	-	(387,344)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	10,594	(972,067)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	43,437	1,010,096
CASH AND CASH EQUIVALENTS, END OF PERIOD	$54,031	$38,029

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

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	Six Months Ended June 30, 2012	2011
Cash paid for:		
Interest	$-	$80,286

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
June 30, 2012 (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, 2011 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, 2011 (the “Form 10-K”), filed on April 16, 2012.

Recently Issued Accounting Pronouncements

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

2. LIQUIDITY AND CAPITAL RESOURCE MATTERS

We have incurred significant losses to date, and at June 30, 2012, we had an accumulated deficit of approximately $52 million. In addition, broad commercial acceptance of our technology is critical to the Company’s success and ability to generate future revenues. At June 30, 2012, our total cash and cash equivalents were approximately $54,000, as compared to approximately $43,000 at December 31, 2011.

As discussed below, the Company has financed itself in the past through access to the capital markets by issuing secured and convertible debt securities, convertible preferred stock, common stock, and recently through factoring receivables. We currently require approximately $385,000 per month to conduct our operations, a monthly amount that we have been unable to achieve through revenue generation.

If the Company is unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained by the Company in order to meet its needs, or that such financing would not be dilutive to existing shareholders.

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The accompanying 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 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 meet its financing requirements on a continuing basis, and become profitable in its future operations. The accompanying 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. SHARE BASED COMPENSATION

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

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011
Selling, general and administrative	$ 9,727	$ 2,064
Research, development and engineering	6,206	7,127
	$ 15,933	$ 9,191

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Selling, general and administrative	$ 13,385	$ 6,160
Research, development and engineering	24,724	30,169
	$ 38,109	$ 36,329

4. EARNINGS (LOSS) PER SHARE COMMON STOCK ("EPS")

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

The reconciliation of the numerators of the basic and diluted EPS calculations was as follows for both of the following three and six month periods ended June 30:

	Three Months ended June 30,		Six Months ended June 30,	
	2012	2011	2012	2011
Basic Numerator:				

(Loss) available to common stockholders	$ (613,419)	$ (594,224)	$ (249,921)	$ (354,154)
Basic Denominator	78,155,413	78,155,413	78,155,413	78,155,413
Per Share Amount	(0.01)	(0.01)	0.00	0.00

There were no weighted average shares of common stock that were included in the diluted per share calculation for the three and six month periods ended June 30, 2012, and June 30, 2011, as the effects would have been anti-dilutive.

	Three Months ended June 30, 2012	2011	Six Months ended June 30, 2012	2011
Dilutive Numerator:				
(Loss) available to common stockholders	$ (613,419)	$ (594,224)	$ (249,921)	$ (354,154)
Dilutive Denominator:	78,155,413	78,155,413	78,155,413	78,155,413
Per Share Amount	(0.01)	(0.01)	0.00	0.00

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 June 30, 2012	2011	Six Months Ended June 30, 2012	2011
Stock options	4,578,749	2,527,140	4,578,749	2,507,140
Warrants	8,250,000	9,986,615	8,250,000	9,986,615
Total	12,828,749	12,513,755	12,828,749	12,493,755

In addition, 741 and 625 options for the three and six months ended June 30, 2012, respectively, were excluded from the diluted per share calculation as the Company incurred a loss for both periods.

5. NOTE RECEIVABLE

As consideration for the Asset Sale of its Law Enforcement division (the “Business”) to InterAct911 Mobile Systems, Inc. in 2009, the Buyer paid the Company an aggregate purchase price of approximately $11.3 million. The consideration consisted of cash payments totaling $7.3 million and the issuance of a promissory note (the “Note”) in the original principal amount of $4 million in favor of the Company. The Note earned interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding.

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

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

Effective as of May 19, 2011, the Buyer exercised its option to prepay the balance due of $3,222,000 under the Note. In consideration for the early payment from the Buyer, the Company accepted a $150,000 discount on the principal amount due, of which $50,000 was effectively absorbed by the Secured Promissory Noteholders (see “Note 6 – Notes Payable”). The total amount received by the Company was $3,113,654 which included principal amount of $3,222,000, interest income of $30,888 and a reimbursement of legal fees incurred of $10,766 net of the discount of $150,000.

6. NOTES PAYABLE

The 2010 Exchange Agreement

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

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

Effective as of May 20, 2011, the Company exercised its option to prepay the balance due of $3,157,759 owed to Shaar on its Secured Promissory Note. In consideration of the $150,000 discount granted by the Company for the early payment of the Note Receivable (see “Note 5 — Note Receivable”), the Company’s Secured Promissory Note holders agreed to effectively absorb $50,000 of the discount, with the remainder borne by the Company. The discount was prorated to both Note holders which reduced the Shaar payment by $45,624 and the principle amount owed on the Colatosti Note by $4,376. The total amount paid by the Company to Shaar was $3,192,421 and included principal of $3,157,759, interest of $80,286 less Shaar’s share of the discount described above.

The principal and interest under the Colatosti Note is scheduled to be repaid by the Company in cash on December 31, 2012. The Company’s obligations under the Colatosti Note are secured by substantially all of the Company’s assets. At both June 30, 2012 and December 31, 2011, the Colatosti note amounted to $346,428.

7. SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of Biometric products. Geographically, North American sales accounted for approximately 86% and 68% of the Company’s total sales for the three months ended June 30, 2012 and 2011, respectively, and were approximately 94% and 41% of the Company’s total sales for the six months ended June 30, 2012 and 2011, respectively.

8. FAIR VALUES OF FINANCIAL INSTRUMENTS

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

9. MAJOR CUSTOMERS AND ACCOUNTS RECEIVABLE

The Company had certain customers whose revenue individually represented 10% or more of the Company's total revenue, or whose accounts receivable balances individually represented 10% or more of the Company's total accounts receivable, as follows:

For the three months ended June 30, 2012 and 2011, two customers accounted for 86%, and one customer accounted for 32% of revenue, respectively. For the six months ended June 30, 2012 and 2011, four customers accounted for 94%, and one customer accounted for 58% of revenue, respectively.

At June 30, 2012, one customer accounted for 84% of accounts receivable. At December 31, 2011, one customer accounted for 75% of accounts receivable.

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

CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

The information contained in this Report on Form 10-Q and in other public statements by the Company and Company officers include or may contain certain forward-looking statements. All statements other than statements of historical facts contained in this Report on Form 10-Q, including statements regarding our future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words "anticipate," "believe," "estimate," "will," "may," "future," "plan," "intend" and "expect" and similar expressions generally id 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 as a fingerprint biometric technology company. Biometric technology is the science of analyzing specific human characteristics which are unique to each individual in order to identify a specific person from a broader population. First incorporated as BBG Engineering, the company became SAC Technologies in 1994. The BIO-key name was introduced in 2002.

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

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

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, 2011. There have been no material changes to our critical accounting policies and estimates from those disclosed in our 10-K filed on April 16, 2012.

RECENT ACCOUNTING PRONOUNCEMENTS

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

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2012 AS COMPARED TO JUNE 30, 2011

Consolidated Results of Operations - Percent Trend

	Three Months Ended June 30, 2012	2011
Revenues		
Services	30%	15%
License fees and other	70%	85%
	100%	100%
Costs and other expenses		
Cost of services	5%	3%
Cost of license fees and other	22%	27%
	27%	30%
Gross Profit	73%	70%
Operating expenses		
Selling, general and administrative	138%	65%
Research, development and engineering	49%	29%
	187%	94%
Operating profit (loss)	-114%	-24%
Other income (expenses)	-1%	-36%
Net Loss	-115%	-60%

	Three months ended June 30, 2012	2011	$ Change	% Change
Revenues				
Service	$ 167,313	$ 150,627	$ 16,686	11 %
License & other	365,400	833,526	(468,126)	-56 %
Total Revenue	$ 532,713	$ 984,153	$ (451,440)	-46 %
Cost of goods sold				
Service	$ 23,665	$ 31,329	$ (7,664)	-24 %
License & other	118,120	261,247	(143,127)	-55 %
Total COGS	$ 141,785	$ 292,576	$ (150,791)	-52 %

Revenues

For the three months ended June 30, 2012 and 2011, service revenues included approximately $167,000 and $151,000, respectively, of recurring maintenance and support revenue, and no non-recurring custom services revenue for either three month periods. Recurring service revenue increased 11% from 2011 to 2012 as the Company continued to bundle maintenance agreements to its expanding customer license base, and renewed existing maintenance agreements from its legacy customers.

For the three months ended June 30, 2012, license and other revenue (comprised of third party hardware and royalty) decreased 56% from the same period ending June 30, 2011. The Company realized an approximately $271,000 decrease (68%) in its core software license revenue primarily as a result of a lag in implementation of biometrics deployments in the blood bank sector. Blood banks have contributed significant revenue in the past, and since their consolidations, have extended their pre-implementation testing phase. Third-party hardware sales decreased by approximately $192,000 (47%), as a result of decreased demand from an existing OEM partner and decrease in new Healthcare deployments. The Company’s royalty income was derived from an OEM agreement, and resulted in a 16% decrease in revenue to $22,989 from $27,334 for the three months ended June 30, 2012 and 2011, respectively.

Costs of goods sold

For the three months ended June 30, 2012, cost of service decreased approximately $8,000 as a result of decreases to personnel related costs. License and other costs for the three months ended June 30, 2012 decreased approximately $143,000 directly associated with the decrease in third party hardware revenue.

Selling, general and administrative

	Three months ended June 30, 2012	Three months ended June 30, 2011	$ Change	% Change
Selling, general and administrative	$ 739,289	$ 638,260	$ 101,029	16 %

Selling, general and administrative costs for the three months ended June 30, 2012 increased 16% from the same period in 2011. Reductions included business taxes, referral fees, and commission expense related to decreased sales. The decreases were offset by an increase in bad debt expense related to a contract whose payments are behind schedule, As a result of the payment delays, the Company has reserved an additional $193,000 to the balance of $386,000 which now represents 75% of the remaining balance owed under the contract.

Research, development and engineering

	Three months ended June 30, 2012	Three months ended June 30, 2011	$ Change	% Change
Research, development and engineering	$ 258,931	$ 287,356	$ (28,425)	-10 %

For the three months ended June 30, 2012, research, development and engineering costs decreased 10% as the Company no longer required additional temporary outside services for a specific project from the same period in 2011.

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Other income and expense

	Three months ended June 30,			
	2012	2011	$ Change	% Change
Interest income	$ 2	$ 30,898	(30,896)	-100 %
Interest expense	(6,129)	(291,083)	284,954	-98 %
Net discounts of notes payable and receivable	-	(100,000)	100,000	-100 %
Total	$ (6,127)	$ (360,185)	$ 354,058	-98 %

Interest income for the quarter ended June 30, 2011, was attributable to the Note Receivable, which was fully paid in May 2011.

Interest expense for the quarter ended June 30, 2012 was for the holder of the Secured Note. Interest expense during 2011 was comprised of approximately $258,000 of non-cash amortization of the discount attached to the Secured Notes and $33,000 owing to the holders of the Secured Notes. The Company expects to incur approximately $12,000 in interest expense from its Secured Note until the end of 2012, at which point the Note is expected to be paid in full.

For the quarter ended June 30, 2011, the net discounts of notes payable and receivable were non-cash items with respect to the value of the net early payment discount granted to the holder of the note receivable (see Note 5).

SIX MONTHS ENDED JUNE 30, 2012 AS COMPARED TO JUNE 30, 2011

Consolidated Results of Operations - Percent Trend

	Six Months Ended June 30,	
	2012	2011
Revenues		
Services	29%	13%
License fees and other	71%	87%
	100%	100%
Costs and other expenses		
Cost of services	8%	3%
Cost of license fees and other	9%	14%
	17%	17%
Gross Profit	83%	83%
Operating expenses		
Selling, general and administrative	69%	57%
Research, development and engineering	26%	24%
	95%	81%
Operating (loss) profit	-12%	2%

Other income (expenses)	-1%	-17%
Net Loss	-13%	-15%

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	Six months ended June 30, 2012	Six months ended June 30, 2011	$ Change	% Change
Revenues				
Service	563,168	308,972	254,196	82 %
License & other	1,379,972	2,080,294	(700,322)	-34 %
Total Revenue	$ 1,943,140	$ 2,389,266	$ (446,126)	-19 %
Cost of goods sold				
Service	147,682	65,815	81,867	124 %
License & other	175,533	341,633	(166,100)	-49 %
Total COGS	$ 323,215	$ 407,448	$ (84,233)	-21 %

Revenues

For the six months ended June 30, 2012 and 2011, service revenues included approximately $340,000 and $293,000, respectively, of recurring maintenance and support revenue, and approximately $223,000 and $16,000, respectively, of non-recurring custom services revenue. Recurring service revenue increased 16% from 2011 to 2012 as the Company continued to bundle maintenance agreements to its expanding customer license base, and renewed existing maintenance agreements from its legacy customers.

For the six months ended June 30, 2012 and 2011, license and other revenue (comprised of third party hardware and royalty) decreased as a result of several contributing factors. The Company realized an approximately $451,000 decrease (30%) in its core software license revenue primarily as a result two large orders in 2012 equal to 30% less than one large order from a single new customer in 2011. For the six months ended June 30, 2012 and 2011 we shipped orders from McKesson for their continued deployment of our identification technology in their AccuDose® product line, and for continued expansion of biometric ID deployments with commercial partners ChoicePoint /Nexis Lexis, Educational Biometric Technology, and Identimetrics. Third-party hardware sales decreased by approximately $241,000 (46%), as a result of decreased demand from an existing OEM partner and smaller Healthcare deployments. The Company's royalty income was derived from an OEM agreement, and resulted in a 14% increase in revenue to $48,097 from $55,894 for the six months ended June 30, 2012 and 2011, respectively.

Costs of goods sold

For the six months ended June 30, 2011, cost of service increased approximately $82,000 as a result of costs associated with non-recurring custom services revenue. License and other costs for the three months ended June 30, 2011 decreased approximately $166,000 directly associated with the decrease in third party hardware revenue.

Selling, general and administrative

	Six months ended June 30, 2012	Six months ended June 30, 2011	$ Change	% Change

Selling, general and administrative	$	1,344,174	$	1,347,964	$	(3,790	)	0	%

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Selling, general and administrative costs for the six months ended June 30, 2012 decreased less than 1% from the same period in 2011. Reductions included commissions for reduced revenue, administrative personnel, professional services and marketing expenses which were offset by an increase in channel marketing expense related to increased non-recurring custom services revenue and bank charges associated with factoring fees and bad debt expense related to a contract whose payments are behind schedule, As a result of the payment delays, the Company has reserved an additional $193,000 for 2012.

Research, development and engineering

	Six months ended June 30, 2012	June 30, 2011	$ Change	% Change
Research, development and engineering	$ 513,417	$ 583,906	$ (70,489)	-12 %

For the six months ended June 30, 2012, research, development and engineering costs decreased 12% as the Company no longer required additional temporary outside services for a specific project from the same period in 2011.

Other income and expense

	Six months ended June 30, 2012	June 30, 2011	$ Change	% Change
Interest income	4	95,030	(95,026)	-100 %
Interest expense	(12,259)	(399,132)	386,873	-97 %
Loss on extinguishment of note receivable and payable	-	(100,000)	100,000	-100 %
Total	$ (12,255)	$ (404,102)	$ 391,847	-97 %

For the six months ended June 30, 2011, the interest income was attributable to the Note Receivable, which was fully paid in May 2011.

Interest expense for the six months ended June 30, 2012 was for the holder of the Secured Note. For the six months ended June 30, 2011, the interest expense was attributable to the Note Payable, of which approximately 10% ($346,000) remains outstanding. Interest expense during 2011 was comprised of approximately $308,000 of non-cash amortization of the discount attached to the Secured Notes and $91,000 owing to the holders of the Secured Notes. The Company expects to incur approximately $12,000 in interest expense from its Secured Note until the end of 2012, at which point the Note is expected to be paid in full.

For the six months ended June 30, 2011, the net discounts of notes payable and receivable were non-cash items with respect to the value of the net early payment discount granted to the holder of the note receivable (see Note 5).

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LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operations during the six months ended June 30, 2012 was approximately $11,000. The cash provided by operating activities was primarily due to the following items:

- Positive cash flows related to a decrease in accounts receivable of approximately $138,000, due to focused collections;
- Negative cash flows from a decrease in deferred maintenance revenues of approximately $86,000;
- The Company recorded approximately $38,000 of charges during the first half of 2012 for the expense of issuing options to employees for services.

There were no cash flows under investing or financing activities during the period.

The Company has a reserve for bad debts of $579,000 which represents 75% of the remaining balance owed under a contract for payments that are behind schedule.

Net working deficit at June 30, 2012 was approximately $1,730,000 as compared to approximately $1,539,000 at December 31, 2011.

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.

As of December 2011, the Company entered into a 24-month accounts receivable factoring arrangement with a financial institution (the “Factor”). Pursuant to the terms of this arrangement, BIO-key, from time to time shall sell to the Factor certain of its accounts receivable balances on a non-recourse basis for credit approved accounts. The Factor shall then remit 75% of the accounts receivable balance to BIO-key (the “Advance Amount”), with the remaining balance, less fees to be forwarded to the Company once the Factor collects the full accounts receivable balance from the customer. Factoring fees range from 2.75% to 15% of the face value of the invoice factored and are determined by the number of days required for collection of the invoice. BIO-key expects to use this factoring arrangement periodically to assist with its general working capital requirements.

Liquidity outlook

At June 30, 2012, our total cash and cash equivalents were approximately $54,000, as compared to approximately $43,000 at December 31, 2011.

As discussed above, the Company has financed itself in the past through access to the capital markets by issuing secured and convertible debt securities, convertible preferred stock, common stock, and recently through factoring receivables. We currently require approximately $385,000 per month to conduct our operations, a monthly amount that we have been unable to consistently achieve through revenue generation. During the first half of 2012, we generated approximately $1,943,000 of revenue, which is below our average monthly requirements

The balance of the Company’s Secured Notes of approximately $346,000 will be due and payable to the holder together with all accumulated and unpaid interest on December 31, 2012.

If we are unable to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we may need to obtain additional financing through the issuance of debt or equity securities, or to restructure our financial position through similar transactions to those consummated during the 2009 to 2010 period.

Due to several factors, including our history of losses and limited revenue, our independent auditors have included an explanatory paragraph in their opinion related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. To the extent that we require such additional financing, no assurance can be given that any form of additional financing will be available on terms acceptable to us, that adequate financing will be obtained to meet our needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or unavailable or we fail to continue to generate meaningful revenue, we may be required to further reduce operating expenses, delay the expansion of operations, be unable to pursue merger or acquisition candidates, or continue as a going concern.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2012. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of June 30, 2012, our CEO and CFO concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

No change in our internal control over financial reporting occurred during the fiscal quarter ended June 30, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 6. EXHIBITS

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

SIGNATURES

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

	BIO-Key International, Inc.
Dated: August 14, 2012	/s/ Michael W. DePasquale Michael W. DePasquale Chief Executive Officer
Dated: August 14, 2012	/s/ Cecilia Welch Cecilia Welch Chief Financial Officer

EXHIBIT INDEX

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

(1) Filed herewith

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