BIO KEY INTERNATIONAL INC
Form 10QSB
May 14, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED MARCH 31, 2002

[_] 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)

MINNESOTA	41-1741861
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

1285 CORPORATE CENTER DRIVE, SUITE # 175, EAGAN, MN 55121

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(651) 687-0414

(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___

Shares of the Registrant's Common Stock, par value $.01 per share, outstanding as of May 9, 2002: 12,685,209.

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BIO-Key International, Inc.
(a Corporation in the Development Stage)
BALANCE SHEETS

	December 31, 2001	March 31, 2002
ASSETS		(Unaudited
CURRENT ASSETS		
Cash and cash equivalents	$ 514,970	$ 111,41
Prepaid expenses	206,634	228,52
Total current assets	721,604	339,93
EQUIPMENT AND FURNITURE AND FIXTURES - AT COST, less accumulated depreciation	--	-
OTHER ASSETS	41,706	108,96
	$ 763,310	$ 448,90
LIABILITIES AND STOCKHOLDERS' DEFICIT		
CURRENT LIABILITIES		
Accounts payable	$ 238,496	$ 380,58

Accrued liabilities	90,575	225,29
Total current liabilities	329,071	605,88
LONG-TERM OBLIGATIONS, net of discount	4,331,238	4,565,19
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' DEFICIT		
Preferred stock - authorized, 5,000,000 shares of $ .01 par value (liquidation preference of $100 per share)		
Series B 9% Convertible; issued and outstanding, 21,430 Shares as of December 31, 2001 and March 31, 2002	214	21
Common stock - authorized, 60,000,000 shares of $.01 par value; issued and outstanding, 12,528,469 and 12,685,209 shares, respectively	125,285	126,85
Additional contributed capital	15,538,025	15,762,85
Deficit accumulated during the development stage	(19,560,523)	(20,612,09
	(3,896,999)	(4,722,17
	$ 763,310	$ 448,90

See accompanying notes to interim financial statements.

BIO-Key International, Inc.
(a Corporation in the Development Stage)
STATEMENTS OF OPERATIONS
(Unaudited)

	Three months ended March 31,		January 7, 1993 (date of inception) through March 31,
	2001	2002	2002
Revenues			
Product sales	$ --	$ --	$ 577,384
Licensing fees	--	--	100,000
Reimbursed research and development	--	--	284,506
Technical support and other services	--	--	429,885
	--	--	1,391,775
Costs and other expenses			

Cost of product sales	--	--	1,736,895
Cost of technical support and other services	--	--	237,317
Selling, general and administrative	414,426	504,731	11,935,865
Research, development and engineering	279,367	287,462	6,093,587
	693,793	792,193	20,003,664
Operating loss	(693,793)	(792,193)	(18,611,889)
Other income (expense)			
Interest income and other	(5,836)	(1,045)	510,181
Interest expense	(48,106)	260,427	(1,589,572)
	(53,942)	(259,382)	(1,079,391)
Loss before extraordinary gain	$ (747,735)	(1,051,575)	(19,691,280)
Extraordinary gain - troubled payable reduction	--	--	300,250
NET LOSS	$ (747,735)	$ (1,051,575)	$(19,391,030)
Loss applicable to common shareholders			
Net loss	$ (747,735)	$ (1,051,575)	$(19,391,030)
Preferred stock dividends and accretion	--	--	(1,199,303)
Loss applicable to common stockholders	$ (747,735)	$ (1,051,575)	$(20,590,333)
Basic and diluted loss Per common share	$ (.07)	$ (.08)	$ (2.77)
Preferred stock dividends and accretion	(.00)	--	(.17)
Loss per common share	$ (.07)	$ (.08)	$ (2.94)
Weighted average number of common shares outstanding	10,282,083	12,500,228	6,985,121

See accompanying notes to interim financial statements

BIO-Key International, Inc.
(a Corporation in the Development Stage)

STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months ended March 31, 2001	Three Months ended March 31, 2002	January 7, 1993 (date of inception) through March 31, 2002
Cash flows from operating activities			
Net loss	$ (747,735)	$(1,051,575)	$(19,391,030)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	7,986	--	242,913
Amortization			
Unearned compensation	--	--	193,333
The intrinsic value of the beneficial conversion feature of the convertible debenture	--	153,954	776,518
Deferred financing costs	21,069	--	426,397
Write-down of inventory	--	--	916,015
Write-down of deferred financing costs	--	--	132,977
Gain on sale of Inter-Con/PC stock	--	--	(190,000)
Revenues realized due to offset of billings against a stock purchase	--	--	(170,174)
Acquired research and development	--	--	117,000
Options and warrants issued for services and other	13,320	94,397	1,495,417
Other	--	--	34,684
Change in assets and liabilities:			
Accounts receivable	2,522	--	--
Inventories	--	--	(916,015)
Prepaid expenses	13,036	(21,886)	(228,520)
Accounts payable	(20,589)	142,091	380,587
Accrued Liabilities	242,343	149,723	1,730,979
Net cash used in operations	(468,048)	(533,296)	(14,448,919)
Cash flows from investing activities			
Capital expenditures	--	--	(242,913)
Proceeds from sales of Inter-Con/PC stock	--	--	190,000
Other	(2,132)	(255)	(41,961)
Net cash used in investing activities	(2,132)	(255)	(94,874)
Cash flows from financing activities			
Net borrowings under short-term borrowing agreements	500,000	--	3,003,000
Issuance of convertible bridge note	--	--	175,000

Issuance of convertible Debentures and Long-Term notes	--	180,000	3,020,000
Issuance of warrants and convertible debentures discount	--	--	830,000
Deferred financing costs	--	(50,000)	(362,977)
Exercise of stock options and warrants	--	--	190,799
Sales of common stock	--	--	7,093,832
Sale of preferred stock and assigned value of warrant	--	--	843,558
Redemption of common stock	--	--	(138,000)
Net cash provided by financing activities	500,000	130,000	14,655,212
Net increase (decrease) in cash and cash equivalents	29,820	(403,551)	111,419
Cash and cash equivalents, at beginning of period	48,830	514,970	--
Cash and cash equivalents, at end of period	$ 78,650	$ 111,419	$ 111,419

See accompanying notes to interim financial statements.

BIO-Key International, Inc.
(a Corporation in the Development Stage)
NOTES TO INTERIM FINANCIAL STATEMENTS
December 31, 2001, and March 31, 2002 (Unaudited)

1. Unaudited Statements

The accompanying unaudited interim financial statements have been prepared by BIO-Key International, Inc. (the "Company") in accordance with accounting principles generally accepted in the United States, pursuant to the rules and regulations of the Securities and Exchange Commission. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted.

In the opinion of management, the accompanying unaudited interim 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 financial statements are 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, 2001.

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 had no significant revenues to date, and has accumulated losses since inception of approximately 19,391,000 of which approximately 1,052,000 was incurred during 2002. As of March 31, 2002 there was a stockholders' deficit of approximately 4,722,000.

The Company is in need of substantial additional capital. The Company is currently considering various alternatives related to raising additional capital including continued funding from an investment group and 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 advancing beyond the development stage, which in turn 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 might be necessary should the Company be unable to continue in existence.

3. Loss Per Common Share

Basic loss per share is calculated by dividing the net loss attributable to common stockholders by the number of weighted average common shares outstanding. Diluted earnings per share are calculated by dividing the net loss attributable to common stockholders by the weighted average common shares, and when dilutive, by including options, warrants and convertible securities outstanding using the treasury stock method. There was no difference between basic and diluted loss per share for all periods presented, because the impact of including options, warrants and convertible securities would be antidilutive.

4. Prepaid Expenses

	December 31, 2001	March 31, 2002
Consulting fees	$ 188,275	$ 199,350
Insurance	18,359	17,811
Rent and other	--	11,359
	$ 206,634	$ 228,520

5. Other Assets

	December 31, 2001	March 31, 2002
Deferred financing costs	$ --	$ 67,000
Patents pending	26,706	26,961
Security deposits	15,000	15,000
	$ 41,706	$ 108,961

Deferred financing costs

In March 2002, the company engaged an investment banking firm to advise the Company regarding rasing additional capital through the potential future issuance of the Company's equity, debt or convertible securities. The firm will be paid a nonrefundable retainer fee of $50,000 and has been granted a warrant to purchase 25,000 shares of the Company's common stock at an exercise price of $1.00 per share through the next four years. The estimated value of the warrant is $17,000.

6. Accrued Liabilities

	December 31, 2001	March 31, 2002
Interest	$ 42,509	$ 148,982
Compensation	36,699	40,733
Other	11,367	35,583
	$ 90,575	$ 225,298

7. Long-term Obligations

As part of the Company's November 2001 recapitalization transaction with an investor group (The Investor), the Investor agreed to provide up to $1,080,000 of additional financing (The Funding Agreement) in incremental monthly installments during the six-month period commencing March 1, 2002, subject to certain conditions. In March 2002, the Company received $180,000 and issued a note payable to the Investor. The terms of the note require the principal to be repaid on September 30,2003, interest to be accrued at 10%, payable semi-annually on April 30 and September 30 commencing September 30, 2002, and provides for conversion of principal and accrued interest into shares of the Company's common stock at a conversion price of $0.75 per share.

8. Stockholders Equity

Conversion of Debt into Common Stock

All of the Company's notes payable to the Investor are convertible into shares of the Company's common stock. During the three-month period ended March 31, 2002, the Investor elected to convert $100,000 of debt into 156,740 shares of common stock.

Increase in Number of Authorized Shares of Common Stock

In February 2002, the Company's shareholders approved an amendment to its articles of incorporation which increased the number of authorized shares of common stock from 20,000,000 to 60,000,000.

Options and Warrants

The following summarizes option and warrant activity since December 31, 2001:

	Number of Shares				
	1996 Plan	1999 Plan	Non-Plan	Warrants	
Balance, December 31, 2001	390,380	1,456,669	1,981,000	5,811,898	9
Granted	--	75,000	--	218,000	
Cancelled	--	75,000	168,000	--	
Balance, March 31, 2002	390,380	1,456,669	1,813,000	6,029,898	9
Available for future grants, March 31, 2002	266,620	543,331	--	--	

9. Events Occurring Subsequent to March 31, 2002

In April and May 2002 and pursuant to the Funding Agreement with the Investor discussed in Note 7, the Company has issued a series of notes payable totaling $430,000.

BIO-Key International, Inc.
(a Corporation in the Development Stage)
NOTES TO INTERIM FINANCIAL STATEMENTS
December 31, 2001, and March 31, 2001 (Unaudited)

10. Supplementary Disclosures of Cash Flow Information

January 7, 1993 (date of inception)

	Three months Ended March 31, 2001	Three months Ended March 31, 2002	through March 31, 2002
Cash paid for:			
Interest	$ --	$ --	$ 28,544
Noncash Financing Activities:			
Conversion of short-term notes, accrued interest and penalties into long-term notes and debentures	--	--	4,567,546
Conversion of convertible debentures, bridge notes, and accrued interest into common stock	--	100,000	2,684,968
Accretion of preferred stock beneficial conversion feature	--	--	877,000
issuance of Series B preferred stock in exchange for Series A preferred stock and cumulative dividends in arrears, thereon	--	--	281,049
Issuance of common stock in exchange for Series A preferred stock and cumulative dividends in arrears, thereon	--	--	24,922
Issuance of warrants or stock effected through reduction of debt	--	32,000	382,000
Unearned compensation reversal related to employee termination	--	--	227,111
Common stock repurchases offset by a reduction in amounts billed to Jasper for research and development	--	--	170,174
Offset deferred offering costs against proceeds of initial public offering, and other	--	--	159,021

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS AND PLAN OF OPERATION

PRIVATE SECURITIES LITIGATION REFORM ACT

The information contained in this Report on Form 10-QSB and in other public statements by the Company and Company officers include or may contain certain forward-looking statements. The words "may" "intend" and similar expressions used in this Report are intended to identify forward-looking statements within the meaning of Section 27A of the U.S. Securities Act of 1933 and Sections 21E of the U.S. Securities Exchange of 1934. You should not place undue reliance on these forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly release the result of any revision of these forward-looking statements to reflect events or circumstances after the date they are made or to reflect the occurrence of unanticipated events. You should also know that such statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions. These factors include, but are not limited to, the Company's ability to sucessfully develop and market its technology and to obtain additional financing as well as those risks described in detail in the Company's Annual Report on Form 10-KSB under the caption "Risk Factors". Should any of these risks or uncertainties materialize, or should any of our assumptions prove incorrect, actual results may differ materially from those included within the forward-looking statement.

PLAN OF OPERATION

The Company is in the business of developing and marketing proprietary biometric technology and software solutions. Biometric technology, the science of analyzing specific human characteristics which are unique to each individual in order to identify a specific person from a broader population, is an emerging technology. Examples of the unique biological characteristics that can be used to identify an individual include fingerprints, iris patterns, hand geometry, voice recognition and facial structure. Fingerprint analysis is an accurate and reliable method to distinguish one individual from another and is viewed as less intrusive than many other biometric identification methods. As a result, fingerprint analysis has gained the most widespread use for biometric identification. Biometric technology represents a novel approach to identity verification which has only been used in limited applications and has not gained widespread acceptance in any commercial or consumer markets.

The Company has pioneered the development of high performance one-against-many, automated, finger identification technology that can be used without the aide of non-automated methods of identification such as a personal identification (PIN), password, token, smart card, ID card, credit card, passport, drivers license or other form of possession based or knowledge based identification.

This advanced BIO-key (TM) identification technology improves both the accuracy and speed of finger-based biometrics and is the only finger identification algorithm that has been certified by the International Computer Security Association(ICSA).

Over the past two years, recognizing the growth in electronic commerce, private networks and related security concerns, the Company has actively positioned its technology for the licensing of a Web-based biometric authentication software solution to e-commerce and other companies conducting business over the Internet. This integrated solution involves the licensing of client and server based software to provide for reliable and cost effective user authentication in connection with the processing of e-commerce transactions or securing access to private networks.

The Company has completed the development of its core technology, has commenced the marketing of its technology and expects to generate revenue from licensing arrangements during 2002.

Although the Company has developed significant identification technology, it has not gained a meaningful commercial acceptance and the Company has only generated minimal revenue since inception. The Company did not generate any revenue during 2000 or 2001. The Company's business model, particularly the Web authentication initiative, represents a novel approach to Internet and network security which as of the date of this Report has not been adopted by any company conducting business over the Internet. There can be no assurance that there will be a demand for such a solution or that the Company will have the financial or other resources necessary to successfully market such a software solution.

The Company believes its existing financial resources will only last through August 2002. The Company's long-term viability and growth will depend upon the successful commercialization of its technologies and its ability to obtain adequate financing, among other matters, as to which there can be no assurances.

MARKET OVERVIEW

Although recent security concerns relating to identification of individuals has resulted in an increased interest in biometrics generally, biometric technology has not gained widespread commercial acceptance. Biometric based solutions compete with more traditional security methods such as keys, cards, personal identification numbers and security personnel, as well as competing biometric technologies including voice, face, iris, hand geometry and blood vessel recognition. The market for business-to-business and business-to-consumer transactions is substantial and continues to grow. Such transactions are subject to fraud based on unauthorized persons gaining access to confidential information. The Company believes that its biometric technology provides a more reliable method for confirming the identity of persons in remote locations than existing traditional methods.

Biometric technology is a novel approach to facility and digital security. Acceptance of biometrics as an alternative to traditional security methods depends upon a number of factors including:

* The reliability of biometric solutions
* Public perception regarding privacy concerns
* Costs involved in adopting and integrating biometric solutions

Commercial markets have been slow to accept biometrics as a viable alternative to traditional security methods. Accordingly, the primary competition for biometric technology has been the traditional security methods described above. With respect to competing biometrics, each has its strength and weaknesses and none has emerged as a market leader. Fingerprint identification is generally viewed as inexpensive and non-intrusive, but also as less accurate. Iris scanning is viewed as extremely accurate, but also as inconvenient to use and expensive. Facial recognition has recently received substantial attention, however, it suffers from accuracy limitations. In summary, the market for biometric technology is undeveloped and evolving.

TECHNOLOGY

The Company has developed proprietary fingerprint identification technology consisting of the following:

* VST(TM) (Vector Segment Technology), the patent pending core algorithm which creates a mathematical representation of a fingerprint based on its particular characteristics.
* Hardware and software which translates and standardizes the image of the fingerprint for computer analysis ("Biometric Solution").

* SDK (Developers Tool Kit), a biometric application development tool which facilitates integration of the Company's technology for vertical market applications.

Utilizing these technologies, the Company is continuing to develop identification products and software solutions which are designed to assure that only individuals comprising an approved fingerprint in an online or embedded database are allowed access to an application through real time authentication with an emphasis on Web based applications.

Vector Segment Technology. The Company's IT security solutions are built around its patent pending VST(TM) (Vector Segment Technology) which processes features of a live fingerprint. These features are reduced to a mathematical representation unique to the individual. When a person seeking access to a computer network or restricted area places his or her finger on a reader, a new mathematical representation is generated which is compared to an on-line database to determine whether it matches any mathematical representation on file. If there is a match, the person is identified and given access to the application, computer network, Web Site or restricted area. This can be accomplished without the use of a key, password, user-Id, card, PIN number or token. The actual fingerprint is not typically stored in the database for commercial applications.

De-coupling of Technologies. In order to effectuate the Company's evolution from a hardware provider to a licensor of software solutions, the Company has modified its core Vector Segment Technology to make it easily adaptable to scanners other than its proprietary readers. In the past, the Company's identification algorithm had required the use of its own high resolution reader technology to provide for reliable identification applications. The further development of the Vector Segment Technology has allowed for the de-coupling of the core identification algorithm from the reader technology allowing the algorithm to be utilized with lower resolution and lower quality readers available from other manufacturers. VST has expanded its hardware independence capabilities with added scanner communications. The Company's finger identification technology is now completely hardware independent and can be integrated with virtually any finger reading devise. Enrollments or capture of an individual's biometric ID can be done on one type of scanner and looked-up or identified for a match on another type of scanner. This is a very unique capability in the biometric market and allows the Company's software to be used and integrated with almost any finger scanner hardware.

Identification Verses Verification Technology. Management believes that the Company's Vector Segment Technology is superior to similar technologies utilized by its competitors. Unlike many of the biometric technologies currently available, the Company's technology can identify the fingerprint of an unknown person by searching a database to determine whether the current scanned mathematical representation matches any previously stored mathematical representation. Most of the Company's fingerprint competitors simply verify that the fingerprint image of a known person matches a previously stored copy or model of that individual's fingerprint. By their very nature, such verification systems require an additional item of data such as a PIN number or access card to initially identify the user. Verification systems, therefore, do not eliminate the need for cumbersome access cards, keys or PIN numbers and the administrative costs associated with the distribution and replacement of such data. By contrast, the Company's identification technology typically does not require any identifying data other than a person's fingerprint. Based on the foregoing, the Company believes that its identification technology provides it with a meaningful competitive advantage in the marketplace. On April 27, 1998, the Company's SACcat(TM) product earned the International Computer Association's first and only fingerprint biometric identification certification.

CURRENT OFFERINGS

The following is a description of the status of each of the Company's current offerings.

SDK. The Company's SDK, a software developers toolkit, will be BioAPI compliant and can be deployed in both Internet and non-Internet applications (single PC or local area network). The BioAPI is a consortium of companies, including Intel and Hewlet Packard, seeking to establish a standard in the biometric market. The BIO-key SDK also supports a fuller, lower level control interface that may offer some integrators more control over their application interface.

WEB-key(TM). WEB-key is a biometric identification/authentication solution designed to secure Web based applications through the use of a Web-based browser plug-in and a server side plug-in. WEB-key is designed to provide security and identification assuring that a remote user is in fact who they say they are without the need of a password, PIN, or smart card. WEB-key protects personal information such as credit card, address, account numbers and other private data by only disseminating such information upon the authorization of the owner of such information as determined by such person's fingerprint.

BUSINESS STRATEGY

The Company's initial goal was to develop automated fingerprint identification products which were portable, easily integrated with existing applications and affordable for mass commercialization and distribution through OEMs, distributors and to a lesser degree, system integrators in the computer network, general access control and other markets. This included the development of readers. During 1998 and 1999 the Company pursued an OEM licensing program and in 2000 the Company developed WEB-key an integrated Web based biometric authentication system.

The Company's current business plan, which continues to evolve, consists of a threefold strategy of:

* continued development of technology
* licensing its core technology to OEMs, system integrators, Internet service providers and software application developers addressing industry-specific applications
* licensing its Web-based biometric authentication software solution to e-commerce and Internet content companies to secure Web based transactions and corporations to secure private networks.

Although the Company has developed significant core identification technology and readers, neither has gained any meaningful commercial acceptance, the Company has only generated minimal revenue since inception and it has not entered into any significant licensing arrangements. In addition, the Company's business model, particularly the Web authentication initiative, represents a unique approach to Internet security, requires the distribution and use of additional peripheral hardware, namely an optical reader, and the integration of client and server software. It has not been adopted by any company that conducts business over the Internet. There can be no assurance that there will be a demand for such a solution or that the Company will have the financial, marketing and human resources necessary to successfully market such a software solution.

Technology Development. Although management believes that the Company's identification technology is one of the most advanced and discriminating fingerprint technologies available on the market today, the markets in which the Company competes are characterized by rapid technological change and evolving standards. In order to maintain its position in the market, the Company will continue to upgrade and refine its existing technologies. During 2002, the Company will continue to focus on enhancing its identification technology for large databases, Web based server authentication applications, including porting to multiple platforms, and peer group reader technology. Successful development of this solution will require additional financing to which there can be no assurance.

WEB BASED BIOMETRIC AUTHENTICATION SOLUTION (WEB-KEY(TM)).

The Company's primary initiative is the licensing of WEB-key(TM), its Web-based, Internet ready three tiered Internet application architecture software security solution. The Company licenses WEB-key(TM) as an integrated solution for securing e-commerce, e-business, and web-based transaction applications, or as a systems developer kit (SDK) for integration into other applications.

This initiative has involved transitioning the Company's technology to focus on identification applications for large databases and Web based server authentication applications, including porting to multiple platforms and peer group reader technology. These efforts have resulted in the de-coupling of the core identification algorithm from the reader technology providing for the algorithm to be utilized with other readers available from other manufacturers. The Company believes that the versatility provided by the de-coupling of the identification algorithm and reader technology will facilitate the pursuit of licensing Web based server authentication applications. Successful execution of this initiative has also required the development of enhanced software to provide an effective interface between client and server-based software. The Company continues to refine this software.

The Web-based server authentication application is an integrated solution involving the distribution of readers and the licensing of client and server based software to provide for reliable and cost effective user authentication in connection with the processing of transactions over the Internet. This solution is also intended to secure other Internet applications such as restricting access to specific Web pages, specific information contained on a Web-site or specific applications. The Company believes it has the opportunity to be the first supplier of a reliable high performance electronic identification and authorization solution which operates effectively without the aid of a personal identification number or password supplied by the user.

Architecture. WEB-key provides an easy-to-use, high-performance and secure method for granting users access via the Internet to proprietary information residing on remote servers.

WEB-key consists of three basic components:

* a finger print scanner
* Vector Segment Technology processing software tightly and securely integrated with a web browser
* an identification database residing on a web server.

The user simply logs-on a computer or application residing on a computer using their fingerprint in lieu of a PIN number, password, user name or smart card. WEB-key begins by processing a raster scan image which is enhanced using WEB-key software integrated into the web browser. The image enhancing employs a variety of proprietary techniques to improve accuracy and protect against spoofing. The WEB-key software then converts the enhanced image into a unique mathematical representation of the fingerprint using Vector Segment Technology. An encrypted print model is generated for transmission across the Internet to the central WEB-key registry. The WEB-key web server de-encrypts the mathematical model which operates as an index key for searching the database for a match. The web server matches the Vector Segment Technology BIO-key against a database of registered users to obtain a match. If a match is found, the user is allowed access to the protected content on a connected web server.

WEB-key provides a reliable and secure user authentication solution. WEB-key takes advantage of new security features in Microsoft's Internet Explorer versions 5.5 SP2 and 6.0, in addition to 1024 bit enhanced encryption capabilities integrated with public/private key pairs. WEB-key has also been integrated with Oracle9IRAC, which offers advanced speed, scalability, and reliance to WEB-key's database tier. Additional tools and software based on VST technology are under development.

Potential Market. The growth of electronic fingerprint identification will be driven by the need for secure access to private applications and proprietary databases residing on both private and public network infrastructures. The scope of these opportunities include:

* corporations that increasingly rely upon the exchange and distribution of proprietary information among

staff using intranet or other private networks
* business-to-business e-commerce among trading partners which share confidential information on a secure basis
* business-to-consumer e-commerce where the e-commerce service provider wants to restrict access to paying subscribers

Although electronic commerce has many benefits, the geographical separation of buyers from sellers creates a significant problem arising from the opportunity for fraud. Firewall and encryption software address important aspects of security but do not address the fraud problem inherent in the potential anonymity of a remote user. Corporate intranets are an equally attractive and compelling market. Corporations increasingly rely upon intranet infrastructure for the dissemination of proprietary business data throughout an organization. Since access rights to different classes of data vary among employees, password identification and authorization is integral to all corporate networks.

The current solution to these issues is the association of passwords and PIN numbers with individuals. This solution requires employees or users to remember or retain a growing number of keys cards, passwords and PIN numbers and employers or Internet companies to periodically change passwords and PIN numbers to maintain their integrity. Since such information can be stolen or shared, they provide no assurance that the user is actually who they claim to be. WEB-key has been designed to address each of these concerns.

The Company believes that replacement of traditional passwords presents a substantial market opportunity. Hamburg & Quist reports that approximately 150 million people use passwords to identify themselves to computer networks and the Internet and that 35%-40% of all calls received by IT help desks involve password issues at a cost of $100 per person per year resulting in enterprise spending of $60 billion on password maintenance. The Company's technology could virtually replace and eliminate the need for passwords at an estimated cost of approximately $20 per person per year while providing a higher assurance of identity security and user convenience. Government, aviation/transportation and enterprise security present significant additional opportunities.

MARKETING AND DISTRIBUTION

The Company's marketing and distribution efforts consist of:

* Development of strategic alliances with technology leaders
* General promotion of biometric technology and the Company's offerings
* Direct technology licensing efforts to, among others, OEMs, application developers and operators of private network.

The Company's current marketing efforts are conducted primarily through direct selling efforts of its Chief Executive Officer, President and other marketing personnel to OEMs, application developers and operators of private networks.

The Company attends and actively participates in various product conferences and conventions in the technology and security industries to generate market awareness of biometric technology generally and the Company's offerings specifically. In this connection, in October 2000, the Company began a collaborative presentation effort with Intel Corporation whereby the Company and Intel created a proof-of-concept demonstration of the Company's WEB-key product. The demonstration was created across the Intel IA32 and Itanium family processor products and was first presented at the Intel Developer Forum (IDF) in February 2001. Proof of concept was presented at WinHec in Anaheim, California on March 25-27, 2001 and RSA in San Francisco, California during April 2001. Intel continues to showcase the Company's biometric IT security solution as a lead application for Intel's next generation Itanium Internet/e-business server and as a solution working with Oracle 9i and Oracles database. Additionally the WEB-key product has been presented in alliance with and part of Intel's exhibit at the Oracle Open World in Berlin and San Francisco. Although the Company intends to participate in events and other conferences with Intel, there can be no assurances that Intel will continue to allow the Company to participate with it at any such events or conferences.

From these efforts, the Company has been aggressively marketing its WEB-key and SDK technology to leads generated from these shows, has entered into evaluation license agreements and expects to begin to generate revenues from these private sector activities later this year.

The Company has also entered into alliances and/or joint sales and marketing agreements with Oracle, Intel, and Siebel Systems to develop and implement new security systems utilizing the Company's technology for the Federal Government. The events of September 11th have heightened the need for securing data dissemination throughout and between government agencies and automating the positive identification of personnel. The Company believes that its finger identification technology coupled with the capabilities of its alliance partners are the most advanced solutions capable of meeting these needs.

The Company is targeting both Internet infrastructure companies and large portal providers as licensees of its WEB-Key solution. On the Internet infrastructure side, the Company is currently seeking to

partner with Internet server manufacturers, providers of database and data warehouse engine software, horizontally positioned application engines, firewall solution providers and peripheral equipment manufacturers. On the portal side, the Company is currently targeting financial service providers such as credit and debit card authorization and issuing institutions, Internet retailers, business-to-business application service providers (ASPs) and corporate intranets.

RESEARCH AND DEVELOPMENT

During fiscal years ended December 31, 2000 and 2001 the Company spent approximately $1,136,000 and $948,000, respectively, on research and development. These costs were principally funded through outside sources of equity and debt financing. During 2002, the Company's research and development effort will be focused on the continued evolution of its Web-based authentication solution and furthering the

VST algorithm and SDK.

EMPLOYEES AND CONSULTANTS

The Company currently employs twelve (12) individuals on a full-time basis; six (6) in engineering, research and development, three (3) in finance and administration and three (3) in sales and marketing. The Company also utilizes four (4) consultants who provide marketing, engineering and management services to the Company. The Company anticipates retaining additional marketing personnel within the next twelve (12) months to execute its business plan.

See the section below captioned "LIQUIDITY AND CAPITAL RESOURCES" for a discussion of the Company's financial resources and requirements.

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2002 AS COMPARED TO THREE MONTH ENDED MARCH 31, 2001

Revenues

The Company does not have significant sales revenue and generated no revenue during the three-month periods ended March 31, 2001 and March 31, 2002. The Company continues to deploy substantially all human and capital resources to executing its business plan targeted at Internet, intranet and electronic commerce security. As a result, the Company's limited resources were used to refine its technology to develop the applications needed to execute against the Company's business plan.

Costs and Other Expenses

The Company did not generate any revenue during the three-month periods ended March 31, 2002 and 2001 and, therefore, did not incur any cost of sales.

Selling, general and administrative expenses increased $90,305 to $504,731 during the three months ended March 31, 2002 as compared to $414,426 for the corresponding period in 2001. Of the increase, approximately $247,000 was due to a increase in marketing costs as the Company focused on marketing its Web-based biometric authentication software solution and approximately $68,000 was due to an increase in professional services costs subsequent to the recapitalization transaction in November 2001. These were offset by an approximate $179,000 decrease of a non-cash accrual of penalties incurred for failing to file a registration statement for the Company's Series A convertible preferred stock, a decrease of approximately $27,000 due to a reduction in general and administrative operating costs, and approximately $19,000 was due to a reduction in salaries and wages for administrative personnel.

Research, development, and engineering expenses increased $8,095 to $287,462 during the three months ended March 31, 2002 as compared to $279,367 for the corresponding period in 2001. Of the increase, approximately $81,000 was due to a increase in wages for development personnel and approximately $15,000 was due to an increase in general development and engineering costs. These were offset by an approximate $88,000 decrease in software sub-contracting costs.

Other income and expense increased $205,440 to $259,382 during the three months ended March 31, 2002 as compared to $53,942 for the corresponding period in 2001. The increase was primarily due to an increase in interest costs associated with the November 2001 restructuring transaction, and new long-term borrowings of $180,000 in March 2002.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities during the three months ended March 31, 2002 was $533,296 compared to $468,048 during the three months ended March 31, 2001. The primary use of cash for both years was to fund the net loss. Net cash used in investing activities for the three months ended March 31, 2002 was $255 compared to net cash used in investing activities of $2,132 for the same period in 2001. Net cash provided by financing activities during the three months ended March 31, 2002 was $130,000 compared to $500,000 in the same period in 2001 and consisted primarily of long-term borrowing activities of $180,000 partially offset by costs related to capital raising efforts.

Working capital decreased $658,479 during the three months ended March 31, 2002 to a deficit of $265,946 as compared to a surplus of $392,533 as of December 31, 2001. This decrease is primarily due to operating losses.

Pursuant to the November 2001 recapitalization transaction with an investment fund (The Fund), the Company obtained $1,065,000 of additional financing through the issuance in 2001 of a secured convertible promissory note (The Secured Note). All existing promissory notes payable to the Fund together with all accrued and unpaid interest due thereon ($3,027,920) were cancelled and converted into the Secured Note. The Secured Note is due September 30, 2003, is secured by substantially all of the Company's assets, including its intellectual property, accrues interest at the rate of 10% per annum payable quarterly in arrears commencing September 30, 2002, may be prepaid without penalty and is convertible into shares of common stock at a conversion price of $0.75 per share. The security interest terminates upon the Company obtaining $5,000,000 of additional equity financing. In this transaction, the Company received net cash proceeds of $1,024,000 after giving effect to offering costs of $40,000.

The Fund has agreed to provide up to $1,080,000 of additional financing in incremental monthly installments during the six-month period commencing March 1, 2002. Any such funding will be provided pursuant to a secured promissory note on the terms described above. The Fund's obligation to provide this financing is conditioned upon:

* The Company being in compliance with all material obligations under the November 26, 2001 funding agreement between the parties, the Secured Note and debentures issued to the Fund pursuant thereto, and the other agreements between the parties.

* The continued truth and accuracy of the representations and warranties of the Company set forth in the funding agreement.

* The average closing bid price of the Company's common

stock during the calendar month preceding the advance exceeding $1.00 per share.

Between March 13, 2002 and May 10, 2002 the company has obtained advances in the aggregate principal amount of $610,000. After the final advance has been made, the Company has agreed to file a registration statement covering the public resale of the shares of common stock issuable upon conversion of the secured promissory notes issued against each advance.

The Company does not currently maintain a line of credit or term loan with any commercial bank or other financial institution.

Primarily all of the Company's interest expense is related to obligations due the Fund.

As of the date of this Report the Company has minimal cash resources and is in need of substantial additional capital to maintain operations beyond August 2002. In this connection the Company has engaged a financial advisor to assist the company in raising additional capital. As of the date of this Report, the Company has not reached any definitive agreement with any potential investor regarding the specific terms of an investment in the Company. 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 stockholders. Management believes it will need $5,000,000 to $7,000,000 to execute its business plan and support operations through 2003.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is not a party to any material pending legal proceeding nor is it aware of any proceeding contemplated by any governmental authority involving the Company.

ITEM 2. CHANGES IN SECURITIES

On March 22, 2002, the Company issued a four-year warrant to purchase 25,000 shares of common stock to Punk, Ziegel & Company, L.P., a financial advisory firm, at an exercise price of $1.00 per share. The warrant is immediately exercisable and was issued in a private placement transaction exempt from the registration requirements of the Securities Act of 1933, as amended, pursuant to Section 4(2) thereunder without payment of underwriting discounts or commissions to any person.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER EVENTS

None

ITEM 6. EXHIBITS

(a) Reports on Form 8-K

None.

SIGNATURES

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

Dated: May 14, 2002 BIO-Key International, Inc.

/s/ Jeffry R. Brown

Jeffry R. Brown, Chief Executive Officer

/s/ Gary Wendt

Gary Wendt, Chief Financial Officer