

SECURITIES & EXCHANGE COMMISSION EDGAR FILING

BIO KEY INTERNATIONAL INC

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-K

**Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934**

For the Fiscal Year Ended December 31, 2010

Commission File Number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of
Incorporation or organization)

41-1741861

(IRS Employer
Identification Number)

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

(Address of Principal Executive Offices) (Zip Code)

(732) 359-1100

Issuer's telephone number, including area code.

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Exchange on which Registered</u>
Common Stock, \$0.0001 par value per share	None

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

The aggregate market value of the registrant's voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, as of the last business day of the registrant's most recently completed second fiscal quarter was \$11,857,318.

As of March 17, 2011, the registrant had 78,155,413 shares of common stock outstanding.

Documents Incorporated by Reference: **None**

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PRIVATE SECURITIES LITIGATION REFORM ACT

All statements other than statements of historical facts contained in this Annual Report on Form 10-K, 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 identify forward-looking statements. Although we believe our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure 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 under the caption “Risk Factors” in Item 1A of this Annual Report 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.

PART I**ITEM 1. DESCRIPTION OF BUSINESS**

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

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

Since our inception in 1993, we have spent substantial time and effort in completing the development of what we believe is the most

discriminating and effective commercially available finger-based biometric technology. During the past six years, our primary focus has shifted to marketing and selling this technology and completing strategic acquisitions that can help us leverage our capability to deliver identification solutions. We have built a direct sales force of professionals, and also team with resellers, integrators and partner networks with substantial experience in selling technology solutions to government and corporate customers.

In 2004, BIO-key acquired Public Safety Group, Inc. (PSG), a privately held company that was a leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology was PocketCop™, a handheld solution that provides mobile officers, such as detectives who are not typically in their vehicles, a hand-held mobile information software solution. Also in, 2004, BIO-key completed a transaction with Aether Systems, Inc. to purchase its Mobile Government Division ("Mobile Government" or "AMG"), a leading provider of wireless data solutions for use by public safety organizations, primarily state, local police, fire and rescue and emergency medical services organizations. Their PacketCluster mobile information software is integrated with 50 separate State/NCIC databases, as well as other state, local and federal databases.

In 2007, BIO-key completed a transaction with ZOLL Data Systems, Inc. ("ZOLL"), a subsidiary of ZOLL Medical Corporation, in which ZOLL acquired substantially all of the assets related to the Company's Fire/EMS Services division. In 2009, BIO-key completed a transaction with InterAct911 Mobile Systems, Inc. (InterAct911), a subsidiary of InterAct911 Corporation, in which InterAct911 acquired substantially all the assets related to the Company's Law Enforcement division.

As a result of these transactions, and as discussed in Note M to the Consolidated Financial Statements included in this report, we have organized the Company into one reporting segment: Biometrics. During the year ended December 31, 2010, the Company continued to focus on its primary objectives of increasing revenue and managing expenses, by developing leadership technology and applications and by providing its customers with high quality support and service.

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Markets

Finger-based Biometric Identification

BIO-key is a leader in finger-based biometric identification. 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 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. BIO-key development tools deliver a tangible return on a security platform investment that can:

- Reduce risk
- Improve user convenience
- Lower operating costs

BIO-key's patented Vector Segment Technology (VST) is the foundation for these solutions. BIO-key's unique solutions provide users with the ability to positively identify themselves to applications with the simple scan of their finger. This capability is a significant improvement in both convenience and security over other alternatives and provides companies with a cost-effective solution to thwart phishing attacks and comply with government regulations and legislation such as FFIEC compliance, HIPAA, HSPD-12, and the Electronic Signatures Act. BIO-key couples these capabilities with device interoperability, system flexibility and scalability.

BIO-key has formed relationships with providers of biometric logon software including Evidian (A Bull Company), Sentillion (A Microsoft Company), Authasas, Softex, Passlogix (An Oracle Company) Indigo, IBM and Computer Associates to provide enterprise-ready SingleSignOn systems to many large companies in the US and abroad. BIO-key has partnership agreements with leading technology companies including Sagem-Morpho, McKesson, LexisNexis, and IBM to deliver advanced biometric applications for government, civil and commercial clients. Through its partnership with Oracle, BIO-key has integrated its biometric technology into the entire Fusion Middleware and Identity Management software stack to offer all of Oracle customers a scalable biometric authentication solution. Also, BIO-key has integrated VST to a physical access solution developed and distributed by its partner NextGenID. This solution has been deployed across the US at many leading companies.

- *Growth potential*—As the provider of the core technology, BIO-key's greatest growth potential is as a partner with companies that offer applications that address growing concerns related to quickly and accurately identifying individuals for both commercial and civil applications and thwarting the potential for identity theft.

For example, BIO-key, along with partners, has deployed biometric logical and physical access solutions. These include working with Allscripts to provide their users of electronic health records secure and convenient access to records protected by biometric security. BIO-key also provides IBM with strong network based authentication to their large portfolio of TAM ESSO users.

Products

The Company's biometric identification technology improves both the accuracy and speed of identifying individuals. The Company's proprietary biometric technology extracts unique data from a fingerprint and uses it to positively identify an individual. The technology has been built to be completely scalable to handle databases containing millions of fingerprints. BIO-key achieves the highest levels of discrimination

without requiring any other identifying data—like a userID, smart card, or token. BIO-key’s core technology supports interoperability on over 40 different commercially available readers. This interoperability is a key differentiator for BIO-key in the biometric market. BIO-key has full support for industry standards and received National Institute of Standards and Technology (“NIST”) certification on its ability to support HSPD-12 supported INCITS-378 templates. We believe we have the largest deployment of ISO standard templates in the world with over 300 million created in Bangladesh. Extending our products to support standards enables BIO-key to participate in large government projects like Transportation Workers Identification Card (TWIC), Registered Traveler projects, PIV initiatives, and FIXS consortium solutions. We believe our fingerprint identification technology has a broad range of information security and access control applications, including:

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- Securing Internet sites and electronic transactions
- Securing access to logical networks and applications
- Securing access to buildings and restricted areas
- Providing fast, accurate member identification services
- Securing mobile devices such as biometric enabled handhelds and PDA’s
- Preventing identity theft through positive user identification and false alias validation

BIO-key’s finger identification algorithm—Vector Segment Technology (VST™) is the core intellectual property behind its full suite of biometric products that include:

- **Vector Segment Technology SDK (VST)**—BIO-key’s biometric software development kit (“SDK”) that provides developers the ability to take advantage of a highly accurate, device interoperable algorithm. VST is available as a low level SDK for incorporation into any application architecture to increase security while not sacrificing convenience. VST runs on Windows, Linux or Solaris systems.
- **True User Identification ®**—BIO-key’s biometric identification solution that offers large scale one to many user lookup with nothing but a single fingerprint. This solution enables customers to perform false alias checks and manage fraudulent access to systems. True User Identification leverages commercially available databases, like Oracle, to scale the identification capabilities to millions of users. The solution also runs on commercially available hardware making it truly scalable for any size system.
- **WEB-key ®**—BIO-key’s biometric security platform for managing fingerprint authentication across unprotected networks including the Internet. It extends all features and functionalities of the VST algorithm to customers looking to add an enhanced level of security to their thin client and client/server applications. WEB-key currently is supported by both Windows and Linux operating systems.
- **Biometric Service Provider™**—BIO-key provides support for the BioAPI (a standards based solution meeting worldwide needs) for a compliant interface to applications using biometrics for verification and identification. BIO-key enhances the traditional use of the BioAPI by adding support for CE devices, supporting identification calls and also providing a single user interface for multiple fingerprint readers.
- **ID Director™**—BIO-key’s solution for single sign on integration with Computer Associates SiteMinder, Oracle’s Fusion Middleware SSO, and other solutions, utilizing the power and security of WEB-key. This solution provides a simple to implement, custom authentication scheme for companies looking to enhance authentication. ID Director can easily add a level of security and convenience to the transaction level of any application.

Current Business Plan

BIO-key’s current business plan is to:

- **License its core technology “VST” and True User Identification®** to original equipment manufacturers, systems integrators, and application developers who develop products and applications that utilize its biometric finger matching solutions.
- **License WEB-key®**, the Company’s security centric web-based biometric authentication solution.
- **Integrate its core technology competencies** to leverage new business opportunities and develop new markets for its innovative products.

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Competition

In addition to companies that provide existing compliance methods of restricting access to facilities and logical access points such as pass cards, PIN numbers, passwords, locks and keys, there are numerous companies involved in the development, manufacturing and marketing of fingerprint biometrics products to commercial, government, law enforcement and prison markets. These companies include, but are not limited to, 3M, Cogent, NEC, L-1 Identity Solutions and Sagem-Morpho.

The majority of sales for automated fingerprint identification products in the market to date have been deployed for government and law enforcement applications.. The consumer and commercial markets represent areas of significant growth potential for biometrics. Additionally, the majority of companies competing for commercial opportunities are in the business of selling scanning devices and these companies tie their algorithm to specific hardware. BIO-key has created a “device independent” algorithm that provides flexibility in choosing the correct device to fit the application served.

BIO-key has found that commercial markets have been slow to widely purchase biometrics as a viable alternative to their current security methods. As a result, the primary competition for biometric technology consists of traditional security methods such as passwords, PINs, cards and tokens.

With respect to competing biometrics technologies, each has its strength and weaknesses and none has emerged as a market leader:

- *Fingerprint identification* is generally viewed as inexpensive and non-intrusive.
- *Iris scanning* is viewed as accurate, but the hardware is significantly more expensive.
- *Facial recognition* can have accuracy limitations and is typically highly dependent on ambient lighting conditions, angle of view and other factors.

The market for biometric technology continues to evolve. Computer breaches, identity theft, phishing and other events in the recent past are driving a large-scale shift to biometric deployments. In addition, companies such as IBM, Dell and HP have all introduced computers with integrated finger scanning devices to complement the conventional username/password technique since it is highly susceptible to hackers and security breaches. BIO-key supports these integrated devices for broader enterprise level security solutions.

BIO-key believes that the next wave of opportunity for finger biometrics is the mobility market where a number of Smartphone and PDA manufacturers are incorporating finger scanners in their devices for more convenient secure access to the handset itself and ultimately for applications. Our secure “one to many” technology framework can provide a “finger only” access to any application via the web or a 3G/4G or local area network.

Marketing and Distribution

BIO-key’s marketing and distribution efforts comprise the following major initiatives:

- Over the past few years, BIO-key has strengthened its alliance with Oracle and has been recognized as a Certified Partner in the Oracle Partner Network. BIO-key supports the Oracle e-business suite of applications and provides the biometric enabler for the Oracle Single Sign on product. As an Oracle development partner, BIO-key provides the underlying database used for true user identification and on demand alias checking. As a development partner, BIO-key participates in Oracle Trade Shows such as Oracle Open World and Oracle Apps World.
- BIO-key has strategic alliances with technology leaders including Oracle, Computer Associates, IBM, AT&T, and others.
- BIO-key is also promoting biometric technology and its offerings through industry trade shows, public speaking

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engagements, press activities and partner marketing programs

- BIO-key is directing licensing efforts to original equipment manufacturers, application developers and system integrators.
- BIO-key is continuing to build a reseller, integrator and partner network as well as a direct sales team.

Addressing the Market

Following are the specific marketing/sales programs in place:

- *Direct Selling Efforts*— BIO-key’s direct sales force focuses on OEMs and large entities in the commercial and Government markets. The sales team has extensive sales experience and expertise in emerging biometric technologies. The BIO-key sales force is rounded out by Inside Sales, which is responsible for maintaining and supporting our existing installed base, acting as a front-line support for any inquiries on our product line, and facilitating activities that make the field team more productive.
- *Conferences and Trade Shows*— BIO-key attends and actively participates in various product-related conferences and trade shows in

the technology and security industries to generate market awareness of biometric and wireless mobile data technology generally and our offerings specifically.

- *Strategic Alliance*— BIO-key's strategic alliances and reseller agreements with other vendors play a significant role in our overall sales efforts. In the past year, BIO-key has initiated and bolstered numerous important and promising long-term relationships. Just a few examples include:
 - BIO-key is an active member in CA, IBM and Oracle partner programs, delivering authentication and identification solutions integrated with their Identity Management platform to their customers worldwide.
 - BIO-key is focusing on specific vertical markets including healthcare where it continues to grow on successful integration of its identification technology to provide convenient, accurate and fast user identification in partner solutions including McKesson and Allscripts

Licensing

BIO-key targets both Internet infrastructure companies and large portal providers as possible licensees for its WEB-key® solution. On the Internet infrastructure side, BIO-key seeks 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, BIO-key is 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. In the past five years, BIO-key has undertaken a WEB-key® and VST direct selling effort, and entered into license agreements with OEMs and system integrators to develop applications for distribution to their respective customers.

BIO-key is also addressing the security needs of application providers in the following vertical markets:

- *Government*—Using BIO-key's technology, Northrup Grumman deployed an application within the Department of Defense to cross-credential visitors and contractors to certain military bases. Also BIO-key, in conjunction with MorphoTrak, is providing the finger matching platform for the FBI's Next Generation IAFIS system, which today is one of the world's largest biometric systems.
- *Education*—Educational Biometric Technologies and Identimetrics have incorporated BIO-key technology to enable school children to pay for school lunch programs and checkout library books using their fingerprints. VST technology enables schools to enroll these children and reduces the administrative costs of managing passwords and

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collecting payments.

- *Commerce*: LexisNexis has implemented various solutions in thousands of locations in over 70 countries using BIO-key's VST technology to reduce fraud and identity theft.
- *Patient Records and Information Management*: Allscripts has integrated and deployed BIO-key's biometric solution as a standard part of its Enterprise EHR solution. The integrated solution has been deployed at George Washington University, Holzer Clinic, Medisync, and many other Allscripts customers. HBOC, one of the largest healthcare patient records and information management companies, has integrated BIO-key technology into their portal and has deployed their solution in a pilot for the Baptist Hospital System. EPIC, another well recognized company, has integrated BIO-key technology into their information management systems. Also, the Indiana Blood Center, Oklahoma Blood Center and the Institute for Transfusion Medicine in Pittsburgh are incorporating BIO-key's large scale identity assurance platform to provide a safe, secure and convenient means for donors to confirm their identity. McKesson Provider Services has incorporated BIO-key's "one-to-many" finger matching software into their Accudose line of medication and supplies dispensing systems solutions and is selling that equipment to clinics and hospitals nationwide. Sentillion (A Microsoft Company) and Healthcast are using BIO-key technology for the single sign on process.
- *Financial*: BIO-key is working with several companies focusing on financial applications such as point of sale systems and employee trusted identification cards, as well as customer facing applications over the Internet. BIO-key has also begun work with several financial institutions to incorporate its technology for secure access to money transfers for institutional customers.

Intellectual Property Rights

We believe that our intellectual property is important to our biometric operation:

- *Patents*—our biometrics segment uses patented technology and trade secrets developed or acquired by us.

In May 2005, the U.S. Patent & Trademark Office issued us a patent for our Vector Segment fingerprint technology (VST), BIO-key's core biometric analysis and identification technology.

On August 29 2006, BIO-key announced that the Company's patent for biometric identification indexing, a core feature of its VST™

software, has been granted in Europe. In addition, a WEB-key® authentication security patent for “Systems and Methods of Secure Biometric Authentication” has been issued in South Africa. These patents enhance the worldwide protection of BIO-key’s technology. The European patent for VST, which provides BIO-key with protection of its intellectual property in Europe, was issued on March 29, 2006 and covers a similar set of claims for a patent BIO-key was granted in 2005 in the United States.

On October 3, 2006, BIO-key announced that the Company’s patent for a biometric authentication security framework has been granted by the U.S. Patent & Trademark Office. The patent No. 7,117,356 was issued to BIO-key for a biometric authentication security framework that enhances commercial and civil biometric use. BIO-key’s authentication security framework protects privacy and security while also facilitates ease of use of biometric systems. The technology that this patent is based on is the foundation for authentication security as incorporated in BIO-key’s WEB-key® product line. WEB-key is a mature enterprise authentication solution that functions in a wide variety of application environments. The solution supports a variety of implementation alternatives including card technologies for ‘two-factor’ authentication and also supports ‘single-factor’ authentication. Partners and customers implementing BIO-key’s WEB-key software to provide convenient and secure user identity include a number of institutions including the Allscripts Healthcare Solutions, American Association of Medical Colleges, Empresa de Telecomunicaciones de Bogotá (Columbia) and Iomedex Corporation.

On January 11, 2007, BIO-key announced that the U.S. Patent & Trademark Office has issued US patent No. 7,155,040 covering BIO-key’s unique image processing technology, which is critical for enhancing information used in the extraction of biometric minutiae. The issued patent protects a critical part of an innovative four-phase image enhancement process developed by BIO-key, and represents the third U.S. patent granted to the company for its biometric technology.

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On April 15, 2008, BIO-key announced that the U.S. Patent and Trademark Office has issued US patent No. 7,359,553 covering BIO-key’s image enhancement and data extraction core algorithm components. The solution protected under this recently issued patent provides the capability to quickly and accurately transform a fingerprint image into a computer image that can be analyzed to determine the critical data elements

On October 15, 2008 BIO-key announced that the U.S. Patent and Trademark Office has issued US patent No. 7,415,605 for the Company’s “Biometric Identification Network Security” method. The solution protected under this recently issued patent provides a defense against hackers and system attacks, while leveraging the industry standard Trusted Platform Module (TPM) specification for encryption key management.

On December 3, 2008 BIO-key announced that the U.S. Patent and Trademark Office has issued US patent No. 7,454,624 for the Company’s “Match Template Protection within a Biometric Security System” method. The solution protected under this recently issued patent limits the scope of enrollment templates usage and also eliminates the need for revocation or encryption processes, which can be expensive and time consuming.

On March 10, 2009 BIO-key announced that the U.S. Patent and Trademark Office has issued US patent No. 7502938 for the Company’s “Trusted Biometric Device” which covers a simple, yet secure method of protecting a user’s biometric information. It covers the transmission of information from the point the information is collected at the biometric reader until the data reaches the computer or device that is authenticating the user’s identity.

On May 26, 2009 BIO-key announced that the U.S. Patent and Trademark Office has issued US patent No. 7539331 for the Company’s “Image Identification System” method for improving the performance and reliability of image analysis within an image identification system.

- *Trademarks*— We have registered our trademarks “BIO-key”, “True User Identification”, and “WEB-key with the U.S. Patent & Trademark Office.
- *Copyrights and trade secrets*—We take measures to ensure copyright and license protection for our software releases prior to distribution. When possible, the software is licensed in an attempt to ensure that only licensed and activated software functions to its full potential. We also take measures to protect the confidentiality of our trade secrets.

Research and Development

Our research and development efforts are concentrated on enhancing the functionality, reliability and integration of our current products as well as developing new and innovative products for biometrics. Although BIO-key believes that its identification technology is one of the most advanced and discriminating fingerprint technologies available today, the markets in which BIO-key compete are characterized by rapid technological change and evolving standards. In order to maintain its position in the market, BIO-key will continue to upgrade and refine its existing technologies. In 2006, BIO-key announced the launch of IdentityMatch, our fingerprint identification system. IdentityMatch offers a tool for agencies to store and search fingerprints and the associated demographic data, the ability to compare new prints with those previously captured as a low-cost AFIS alternative or to be used for a wide variety of routine identification transactions not supported by AFIS.

During the fiscal years ended December 31, 2010 and 2009, BIO-key spent approximately \$1,056,000 and \$927,000 respectively, on its Biometric segment’s research, development and engineering. BIO-key’s limited customer base during that time did not directly bear these costs, which were principally funded through outside sources of equity and debt financing.

Government Regulations

BIO-key is not currently subject to direct regulation by any government agency, other than regulations generally applicable to businesses or related to specific project requirements. In the event of any international sales, the company would be subject to various domestic and foreign laws regulating such exports and export activities.

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Environmental Regulations

As of the date of this report, BIO-key has not incurred any material expenses relating to our compliance with federal, state, or local environmental laws and does not expect to incur any material expenses in the foreseeable future.

Employees and Consultants

As of March 1, 2011, BIO-key employed fourteen (14) individuals on a full-time basis five (5) in engineering, customer support, research and development; four (4) in finance and administration; and five (5) in sales and marketing. BIO-key also uses the services of two (2) consultants (full-time), who provide engineering and technical services, one (1) part-time contracts administrator, and one (1) part-time sales support.

ITEM 1A. RISK FACTORS

Set forth below are the risks that we believe are material to our investors. This section contains forward-looking statements. You should refer to the explanation of the qualifications and limitations on forward-looking statements appearing just before our Description of Business section above.

Business and Financial Risks

Based on our lack of significant revenue since inception and recurring losses from operations, our auditors have included an explanatory paragraph in their opinion as to the substantial doubt about our ability to continue as a going concern.

Due to, among other factors, our history of losses (excluding gains from valuation changes in embedded derivatives) and limited revenue, our independent auditors have included an explanatory paragraph in their opinion for the year ended December 31, 2010 as to the substantial doubt about our ability to continue as a going concern. Our financial statements have been prepared in accordance with accounting principals generally accepted in the United States, which contemplate that we will continue to operate as a going concern. Our financial statements do not contain any adjustments that might result if we are unable to continue as a going concern.

Since our formation, we have historically generated minimal revenue and have sustained substantial operating losses.

As of December 31, 2010, we had working capital of approximately \$88,000 and an accumulated deficit of approximately \$50,400,000. Since our inception, we have focused almost exclusively on developing our core technologies and, until the fourth quarter of 2004 had not generated any significant revenue. In 2009 we sold our Law Enforcement division, losing the benefit of significant recurring revenue streams. In order to increase revenue, we have developed a direct sales force and anticipate the need to retain additional sales, marketing and technical support personnel and may need to incur substantial expenses. We cannot assure you that we will be able to secure these necessary resources, that a significant market for our technologies will develop or that we will be able to achieve our targeted revenue.

Our biometric technology has yet to gain widespread market acceptance and we do not know how large of a market will develop for our technology.

Biometric technology has received only limited market acceptance, particularly in the private sector. Our technology represents a novel security solution and we have not yet generated significant sales. Although recent security concerns relating to identification of individuals has increased interest in biometrics generally, it remains an undeveloped, evolving market. Biometric based solutions compete with more traditional security methods including keys, cards, personal identification numbers and security personnel. Acceptance of biometrics as an alternative to such traditional methods depends upon a number of factors including:

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- the reliability of biometric solutions
- public perception regarding privacy concerns
- costs involved in adopting and integrating biometric solutions

For these reasons, we are uncertain whether our biometric technology will gain widespread acceptance in any commercial markets or that demand will be sufficient to create a market large enough to produce significant revenue or earnings. Our future success depends, in part, upon business customers adopting biometrics generally, and our solution specifically.

Biometric technology is a new approach to Internet security which must be accepted in order for our WEB-key® solution to generate significant revenue.

Our WEB-key ® authentication initiative represents a new approach to Internet security which has been adopted on a limited basis by companies which distribute goods, content or software applications over the Internet. The implementation of our WEB-key ® solution requires the distribution and use of a finger scanning device and integration of database and server side software. Although we believe our solutions provide a higher level of security for information transmitted over the Internet than existing traditional methods, unless business and consumer markets embrace the use of a scanning device and believe the benefits of increased accuracy outweigh implementation costs, our solution will not gain market acceptance.

Our software products may contain defects which will make it more difficult for us to establish and maintain customers.

Although we have completed the development of our core biometric technology, it has only been used by a limited number of business customers. Despite extensive testing during development, our software may contain undetected design faults and software errors, or “bugs” that are discovered only after it has been installed and used by a greater number of customers. Any such defect or error in new or existing software or applications could cause delays in delivering our technology or require design modifications. These could adversely affect our competitive position and cause us to lose potential customers or opportunities. Since our technologies are intended to be utilized to secure physical and electronic access, the effect of any such bugs or delays will likely have a detrimental impact on us. In addition, given that biometric technology generally, and our biometric technology specifically, has yet to gain widespread acceptance in the market, any delays would likely have a more detrimental impact on our business than if we were a more established company.

While we have commenced a significant sales and marketing effort, we have only begun to develop a significant distribution channel and may not have the resources or ability to sustain these efforts or generate any meaningful sales.

In order to generate revenue from our biometric products, we are dependent upon independent original equipment manufacturers, system integrators and application developers, which we do not control. As a result, it may be more difficult to generate sales.

We market our technology through licensing arrangements with:

- Original equipment manufacturers, system integrators and application developers which develop and market products and applications which can then be sold to end users
- Companies which distribute goods, services or software applications over the Internet

As a technology licensing company, our success will depend upon the ability of these manufacturers and developers to effectively integrate our technology into products and services which they market and sell. We have no control over these licensees and can not assure you that they have the financial, marketing or technical resources to successfully develop and distribute products or applications acceptable to end users or generate any meaningful revenue for us. These third parties may also offer the products of our competitors to end users.

We face intense competition and may not have the financial and human resources necessary to keep up with rapid technological changes, which may result in our technology becoming obsolete.

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The Internet, facility access control and information security markets are subject to rapid technological change and intense competition. We compete with both established biometric companies and a significant number of startup enterprises as well as providers of more traditional methods of access control. Most of our competitors have substantially greater financial and marketing resources than we do and may independently develop superior technologies, which may result in our technology becoming less competitive or obsolete. We may not be able to keep pace with this change. If we are unable to develop new applications or enhance our existing technology in a timely manner in response to technological changes, we will be unable to compete in our chosen markets. In addition, if one or more other biometric technologies such as voice, face, iris, hand geometry or blood vessel recognition are widely adopted, it would significantly reduce the potential market for our fingerprint identification technology.

We depend on key employees and members of our management team, including our Chairman of the Board and Chief Executive Officer, in order to achieve our goals. We cannot assure you that we will be able to retain or attract such persons.

A loss of our current Chairman of the Board of Directors or Chief Executive Officer could severely and negatively impact our operations. Our consulting contract with Thomas J. Colatosti, our Chairman of the Board, expires in December 2011. Mr. Colatosti assists the Company in the areas of strategic planning and corporate finance. In addition, our employment contract with Michael W. DePasquale, our Chief Executive Officer, expires in March 2011. Although the contract does not prevent him from resigning, it does contain confidentiality and non-compete clauses which are intended to prevent him from working for a competitor within one year after leaving our Company. Our success depends on our ability to attract, train and retain employees with expertise in developing, marketing and selling software solutions. In order to successfully market our

technology, we will need to retain additional engineering, technical support and marketing personnel. The market for such persons remains highly competitive and our limited financial resources will make it more difficult for us to recruit and retain qualified persons.

We cannot assure you that the intellectual property protection for our core technology provides a sustainable competitive advantage or barrier to entry against our competitors.

Our success and ability to compete is dependent in part upon proprietary rights to our technology. We rely primarily on a combination of patent, copyright and trademark laws, trade secrets and technical measures to protect our propriety rights. We have filed a patent application relating to both the optic technology and biometrics solution components of our technology wherein several claims have been allowed. Over the last few years, the U.S. Patent Office has issued us a series of patents for our Vector Segment fingerprint technology (VST), and our other core biometric analysis and identification technologies. We cannot assure you that any additional patents will be issued or that we will have the resources to protect any patent from infringement. Although we believe our technology does not currently infringe upon patents held by others, we cannot assure you that such infringements do not exist or will not exist in the future.

We may need to obtain additional financing to execute our business plan, which may not be available. If we are unable to raise additional capital or generate significant revenue, we may not be able to continue operations.

Since our inception, we have not generated significant, recurring revenue (other than revenue from acquired businesses) and have experienced substantial losses. In July and November 2009 we received \$1,000,000 and \$750,000, respectively in gross proceeds through the issuance of unsecured promissory notes. In December 2009 we received approximately \$11,300,000 in net proceeds from the sale of our Law Enforcement division, of which \$7,000,000 was paid in cash, and approximately \$4,000,000 of which is payable in three annual installments. In December 2010, we restructured the payment terms of our \$4,000,000 Note Receivable and exchanged all of our remaining shares of Preferred Stock and outstanding Convertible Notes for Secured Notes.

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.

We cannot assure you that we will ever be able to secure any such financing on terms acceptable to us. If we cannot obtain such financing, we may not be able to execute our business plan or continue operations.

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We may not achieve sustainable profitability with respect to the biometric component of our business if we are unable to maintain, improve and develop the wireless data services we offer.

We believe that our future business prospects depend in part on our ability to maintain and improve our current services and to develop new ones on a timely basis. Our services will have to achieve market acceptance, maintain technological competitiveness and meet an expanding range of customer requirements. As a result of the complexities inherent in our service offerings, major new wireless data services and service enhancements require long development and testing periods. We may experience difficulties that could delay or prevent the successful development, introduction or marketing of new services and service enhancements. Additionally, our new services and service enhancements may not achieve market acceptance. If we cannot effectively develop and improve services we may not be able to recover our fixed costs or otherwise become profitable.

If we fail to adequately manage our resources, it could have a severe negative impact on our financial results or stock price.

We could be subject to fluctuations in technology spending by existing and potential customers. Accordingly, we will have to actively manage expenses in a rapidly changing economic environment. This could require reducing costs during economic downturns and selectively growing in periods of economic expansion. If we do not properly manage our resources in response to these conditions, our results of operations could be negatively impacted.

We granted a blanket security interest in all of our assets to the holders of our secured debt. If we are unable to make our required payments on such debt, or any other event of default occurs, it could have a material adverse effect on our business and operations, and the debt holders may foreclose on our assets.

As part of our secured debt financing transactions, we granted to The Shaar Fund, Ltd. and another holder of such secured debt a blanket security interest in all of our assets, including assets of our subsidiary. See the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this report. In the event we default in payment on such debt, or any other event of default occurs under the relevant financing documents, and the default is not cured, 100% of the outstanding principal amount of the secured notes, plus accrued interest and fees will accelerate and be due and payable in full.

The cash required to pay such accelerated amounts on the secured notes following an event of default would most likely come out of our working capital. As we rely on our working capital for our day to day operations, such a default could have a material adverse effect on our business, operating results, or financial condition to such extent that we are forced to restructure, file for bankruptcy, sell assets or cease operations. In addition, upon an event of default, the holders of the secured debt could foreclose on our assets or exercise any other remedies available to

them. If our assets were foreclosed upon, we would most likely be forced to file for bankruptcy or cease operations; stockholders may not receive any proceeds from disposition of our assets and may lose their entire investment in our stock.

Our obligations to the holders of our outstanding Secured Notes may adversely affect our ability to enter into potential significant transactions with other parties.

We will need to obtain the consent of the holders of our Secured Notes before we can take certain actions, including the issuance of any loan or debt secured by the assets of the Company. Accordingly, unless we obtain such consent, we may not be able to enter into certain transactions.

If the holder of the Note Receivable defaults on its obligations thereunder, such default may adversely affect our ability to repay our obligation due to the holders of our Secured Notes.

We have already extended the original terms of the Note Receivable, as the first scheduled principal repayment, equal to approximately \$1.3 million, was originally due to be paid to BIO-key in December 2010. In connection with this extension, BIO-key deferred \$834,000 of this first payment into three equal payments due over the course of the first three quarters of 2011. If we do not receive timely payments, our ability to repay our obligations under the Secured Notes could be negatively impacted.

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Risks Related To Our Common Stock

We have issued a substantial number of securities that are convertible into shares of our common stock which will result in substantial dilution to the ownership interests of our existing shareholders.

As of December 31, 2010, approximately 16,091,000 shares of our common stock were reserved for issuance upon exercise or conversion of the following securities (at conversion prices applicable as at December 31, 2010):

- 14,672,000 shares upon exercise of outstanding stock options and warrants;
- 1,419,000 shares upon exercise of options available for future grant under our existing option plans; and

The exercise or conversion of these securities will result in a significant increase in the number of outstanding shares and substantially dilute the ownership interests of our existing shareholders.

Applicable SEC Rules governing the trading of “penny stocks” limits the trading and liquidity of our common stock, which may affect the trading price of our common stock.

Our common stock currently trades on the OTC Bulletin Board. Since our common stock continues to trade below \$5.00 per share, our common stock is considered a “penny stock” and is subject to SEC rules and regulations, which impose limitations upon the manner in which our shares can be publicly traded. These regulations require the delivery, prior to any transaction involving a penny stock, of a disclosure schedule explaining the penny stock market and the associated risks. Under these regulations, certain brokers who recommend such securities to persons other than established customers or certain accredited investors must make a special written suitability determination regarding such a purchaser and receive such purchaser’s written agreement to a transaction prior to sale. These regulations have the effect of limiting the trading activity of our common stock and reducing the liquidity of an investment in our common stock.

We do not intend to pay dividends in the foreseeable future.

We have never declared or paid a dividend on our common stock. We intend to retain earnings, if any, for use in the operation and expansion of our business and, therefore, do not anticipate paying any dividends on our common stock in the foreseeable future.

The trading price of our common stock may be volatile.

The trading price of our shares has from time to time fluctuated widely and in the future may be subject to similar fluctuations. The trading price may be affected by a number of factors including the risk factors set forth in this Report as well as our operating results, financial condition, announcements of innovations or new products by us or our competitors, general conditions in the biometrics and access control industries, and other events or factors. Although we believe that approximately 15 registered broker dealers currently make a market in our common stock, we can not assure you that any of these firms will continue to serve as market makers or have the financial capability to stabilize or support our common stock. A reduction in the number of market makers or the financial capability of any of these market makers could also result in a decrease in the trading volume of and price of our shares. In recent years broad stock market indices, in general, and the securities of technology companies, in particular, have experienced substantial price fluctuations. Such broad market fluctuations may adversely affect the future-trading price of our common stock.

ITEM 2. DESCRIPTION OF PROPERTY

We do not own any real estate. We conduct operations from leased premises in Eagan, Minnesota (6,822 square feet), Wall, New Jersey

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ITEM 3. LEGAL PROCEEDINGS

In the normal course of business, the Company periodically becomes involved in litigation. As of December 31, 2010, in the opinion of management, the Company had no pending litigation that would have a material adverse effect on the Company's financial position, results of operations or cash flows.

ITEM 4. RESERVED

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock currently trades on the OTC Bulletin Board under the symbol "BKYI". The following table sets forth the range of high and low bid prices per share of our common stock for each of the calendar quarters identified below as reported by the OTC Bulletin Board. These quotations represent inter-dealer prices, without retail mark-up, markdown or commission, and may not represent actual transactions.

<u>2010:</u>	<u>High</u>	<u>Low</u>
Quarter ended December 31, 2010	\$ 0.19	\$ 0.14
Quarter ended September 30, 2010	0.21	0.10
Quarter ended June 30, 2010	0.23	0.14
Quarter ended March 31, 2010	0.28	0.20
<u>2009:</u>	<u>High</u>	<u>Low</u>
Quarter ended December 31, 2009	\$ 0.30	\$ 0.15
Quarter ended September 30, 2009	0.26	0.10
Quarter ended June 30, 2009	0.17	0.07
Quarter ended March 31, 2009	0.11	0.05

Holders

As of March 1, 2011, the number of stockholders of record of our common stock was 503.

Dividends

We have not paid any cash dividends on our common stock to date, and have no intention of paying any cash dividends on our common stock in the foreseeable future. The declaration and payment of dividends on our common stock is also subject to the discretion of our Board of Directors and certain limitations imposed under the Delaware General Corporation Law. The timing, amount and form of dividends, if any, will depend on, among other things, our results of operations, financial condition, cash requirements and other factors deemed relevant by our Board of Directors.

Equity Compensation Plan Information

For information regarding our equity compensation plans, see Item 12 included in this Annual Report on Form 10-K.

Recent Sales of Unregistered Securities; use of Proceeds from Registered Securities

(a) On July 7, 2009, the Company issued an unsecured promissory note in the aggregate principal amount of \$1,000,000 to The Shaar Fund Ltd. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(b) On November 12, 2009, the Company issued an unsecured promissory note in the aggregate principal amount of \$750,000 to The Shaar Fund Ltd. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without

payment of underwriting discounts or commissions to any person.

(c) On November 12, 2009, the Company entered into a Securities Exchange Agreement with The Shaar Fund Ltd. and Mr. Thomas J. Colatosti (the "Holders"), pursuant to which these investors agreed to exchange 27,932 shares of the

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Company's Series A Convertible Preferred Stock owned by the respective Holders, for 27,932 shares of the Company's Series D Convertible Preferred Stock at an initial fixed conversion price of \$0.30 per share. In addition, the Company issued convertible promissory notes in the aggregate principal amount of \$737,957 to the Holders in exchange for all dividends accrued and unpaid on their Series A Convertible Preferred Stock. Also, the Company issued warrants to the Holders to purchase 5,000,000 shares of common stock at an initial exercise price of \$0.30. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(d) On December 31, 2010, the Company entered into a Securities Exchange Agreement with The Shaar Fund Ltd. ("Shaar") and Mr. Thomas J. Colatosti (collectively, the "Holders"), pursuant to which these investors agreed to exchange all of their 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 each of these investors, for new non-convertible 7% Secured Promissory Notes in the aggregate original principal amount of \$3,508,563. The Company also exchanged all existing 5,108,333 warrants previously issued by the Company to Shaar for a new five-year warrant to allow Shaar to purchase up to an aggregate of 8,000,000 shares of the Company's common stock at an initial exercise price of \$0.30 per share. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

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ITEM 6. SELECTED FINANCIAL DATA

N/A

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion And Analysis Of Financial Condition And Results Of Operations, and other parts of this Report contain forward-looking statements that involve risks and uncertainties. All forward-looking statements included in this Report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth in the section captioned "**RISK FACTORS**" in Item 1A and elsewhere in this Report. The following should be read in conjunction with our audited financial statements included elsewhere herein.

The following Management's Discussion And Analysis Of Financial Condition And Results Of Operations ("MD&A") is intended to help you understand BIO-key International (the "Company", "we", "us" or "our"). MD&A is provided as a supplement to and should be read in conjunction with our financial statements and the accompanying notes. Our MD&A includes the following sections:

OVERVIEW provides a description of our business, the major items that affected our business, and how we analyze our business. It then provides an analysis of our overall 2010 performance and a description of the significant events impacting 2010 and thereafter.

RESULTS OF OPERATIONS provides an analysis of the consolidated results of operations for 2010 compared to 2009.

LIQUIDITY AND CAPITAL RESOURCES provides an overview of our cash flows, financing, contractual obligations, and liquidity outlook.

CRITICAL ACCOUNTING POLICIES provides a discussion of our accounting policies that require critical judgment, assumptions and estimates.

RECENT ACCOUNTING STANDARDS by reference to Note 1 to the Consolidated Financial Statements provides a description of accounting standards which we have not yet been required to implement and may be applicable to our operations, as well as those significant accounting standards which were adopted during 2010.

OVERVIEW

BIO-key develops and markets 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 2004, BIO-key acquired Public Safety Group, Inc. (PSG), a privately held company that was a leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology was PocketCop™, a handheld solution that provides mobile officers, such as detectives who are not typically in their vehicles, a hand-held mobile information software solution. Also in, 2004, BIO-key completed a transaction with Aether Systems, Inc. to purchase its Mobile Government Division ("Mobile Government" or "AMG"), a leading provider of wireless data solutions for use by public safety organizations, primarily state, local police, fire and rescue and emergency medical services organizations. Their

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PacketCluster mobile information software is integrated with 50 separate State/NCIC databases, as well as other state, local and federal databases. In 2007, BIO-key completed a transaction with ZOLL Data Systems, Inc. ("ZOLL"), a subsidiary of ZOLL Medical Corporation, in which ZOLL acquired substantially all of the assets related to the Company's Fire/EMS Services division. In 2009, BIO-key completed a transaction with InterAct911 Mobile Systems, Inc. (InterAct911), a subsidiary of InterAct911 Corporation, in which InterAct911 acquired substantially all the assets related to the Company's Law Enforcement division.

INTRODUCTION

As a result of these transactions, and as discussed in Note M to the Consolidated Financial Statements included in this report, we have organized the Company into one reporting segment: Biometrics. During the year ended December 31, 2010, the Company continued to focus on its primary objectives of increasing revenue and managing expenses, by developing leadership technology and applications and by providing its customers with high quality support and service.

A detailed analysis of operations can be found below.

RESULTS OF OPERATIONS

Consolidated Results of Operations

Two Year % trend

	Years ended December 31,	
	2010	2009
Revenues		
Services	12%	20%
License fees and other	88%	80%
	<u>100%</u>	<u>100%</u>
Costs and other expenses		
Cost of services	3%	4%
Cost of license fees and other	13%	17%
	<u>16%</u>	<u>21%</u>
Gross Profit	<u>84%</u>	<u>79%</u>
Operating expenses		
Selling, general and administrative	88%	144%
Research, development and engineering	30%	39%
	<u>118%</u>	<u>183%</u>
Operating loss	<u>-34%</u>	<u>-104%</u>
Other income (deductions)		
Total other income (deductions)	16%	-9%
Loss from continuing operations	<u>-18%</u>	<u>-113%</u>
Income from discontinued operations	9%	122%
Gain on disposal of discontinued operations	—	190%
Net (loss) income	<u>-9%</u>	<u>199%</u>

Revenues and Costs of goods sold

	2010	2009	2010 - 2009	
			\$ Chg	% Chg
Revenues				
Service	439,759	482,900	(43,141)	-9%
License & other	3,080,649	1,874,382	1,206,267	64%
Total Revenue	\$ 3,520,408	\$ 2,357,282	\$ 1,163,126	49%
Cost of goods sold				
Service	102,661	82,594	20,067	24%
License & other	456,480	421,641	34,839	8%
Total COGS	\$ 559,141	\$ 504,235	\$ 54,906	11%

Revenues

For the years ended December 31, 2010 and 2009, service revenues included approximately \$427,000 and \$332,000, respectively, of recurring maintenance and support revenue, and approximately \$13,000 and \$150,000, respectively, of non-recurring custom services revenue. Recurring service revenue increased 29% from 2009 to 2010 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 year ended December 31, 2010, license and other revenue (comprised of third party hardware and royalty) increased as a result of several contributing factors. The Company realized an approximate \$1 million increase (67%) in its core software license revenue from both new and existing customers. The percentage of license and other revenue as a proportion of total revenue increased from 80% to 87%. Third-party hardware sales increased by approximately \$160,000 (39%) primarily as a result of revenue from new customers in the healthcare industry, who required initial start up investments in hardware, which is not currently a typical scenario across all of BIO-key's target markets. Depending on the size and the timing requirements of the customers' software deployment roadmap, hardware purchases may be solely within the initial software order, or, as with our OEM partners in the healthcare industry, a recurring activity. The Company's royalty income for the year ended December 31, 2010 was derived from a December 2009 OEM agreement, and resulted in a tenfold or 1116% increase in revenue from \$6,615 to \$80,472. The Company expects this revenue stream to be recurring, but at a lower growth rate.

Costs of goods sold

For the year ended December 31, 2010, cost of services increased from 2009 due to increased customer support, as needed for the expanding customer base, and the relative percent of service revenue increased to 23% from 17% over that period. The Company expects these costs will increase in future periods as additional Biometric customers are added.

For the year ended December 31, 2010, cost of license and other increased from 2009 due to an increase in third party hardware costs commensurate with the increase in hardware orders discussed in the "Revenues" section above, offset by a reduction from 2009 costs incurred for non-recurring, temporary outside services hired to augment manpower for support of specific customer orders.

Selling, general and administrative

	2010	2009	2010 - 2009	
			\$ Chg	% Chg
Total	\$ 3,105,291	\$ 3,382,613	\$ (277,322)	-8%

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The overall decline in the total SG&A costs for the year ended December 31, 2010 as compared to 2009 were reductions in legal fees by approximately \$140,000 and professional fees by \$135,000 primarily attributable to the 2009 legal settlement and debt restructuring, payroll expense by \$120,000 as was leveraged by the sale of the Law segment, and a decrease of approximately \$170,000 in non-cash compensation charges. The reduction in expenses was offset by increases in channel marketing fees of approximately \$101,000 related to increased revenue from the healthcare industry, by an increase of \$50,000 for Director fees paid, an increase of \$92,000 related to public relations for consultants and increased show attendance, and increased commission expenses of approximately \$45,000.

Research, development and engineering

	2010	2009	2010 - 2009	
			\$ Chg	% Chg
Total	\$ 1,055,980	\$ 927,241	\$ 128,739	14%

For the year ended December 31, 2010, R & D costs increased as compared to 2009, primarily due to increased consultant expenses of approximately \$120,000, and an increase in non-cash compensation charges of approximately \$8,000. The Company expects to devote similar amounts of funding to its R & D function as in prior years.

Other income and expense

	2010	2009	2010 - 2009	
			\$ Chg	% Chg
Interest income	\$ 241,416	\$ 165,707	\$ 75,709	46%
Interest expense	(711,348)	(75,903)	(635,445)	837%
Derivative and warrant fair value adjustments	1,020,164	(286,492)	1,306,656	-456%
Other expense	—	(9,393)	9,393	-100%
	<u>\$ 550,232</u>	<u>\$ (206,081)</u>	<u>\$ 756,313</u>	<u>-367%</u>

Interest income for the year ended December 31, 2010, was derived from the Note Receivable from InterAct911 Mobile Systems, Inc, while during 2009 the balance was a result of the Company releasing unclaimed penalty reserves from prior years. The Company expects to earn interest income from the Note until the end of 2012, at which point the Note is due to be paid in full. Interest expense for the year ended December 31, 2010 was comprised of approximately \$52,000 owing to the holders of the Convertible Notes, and approximately \$659,000 in non-cash amounts from the amortization of the discount attached to the Convertible Notes. Interest expense during 2009 was from the various Notes and bridging loans the Company had in place until the sale of the Law Division in December 2009, when these instruments were repaid. The Company expects to incur interest expense from its Secured Notes until the end of 2012, at which point the Notes are expected to be paid in full.

For the year ended December 31, 2010, derivative and warrant fair value adjustments increased, when compared to the 2009 period, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt in 2004, 2005, and 2009, as well as with additional derivatives recorded as a result of financings in 2006 and 2009. The fair value of the instruments fluctuated based on; our stock price on the valuation date, the debt conversion price, the volatility of our stock price over a period of time, changes in the value of the risk free interest rate, and the time to maturity of the outstanding debt at different points in time. Stock price is the major driver behind the movement in the Company's balances. As our stock price and the remaining term decreased during 2010, the value of these instruments also decreased, leading to an adjustment to other income; the opposite effect occurred during the 2009 period, as our stock price increased and the term was longer, it resulted in an increase in the value of these instruments, and an adjustment to other expenses.

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DISCONTINUED OPERATIONS

On December 8, 2009, we completed the sale of our Law Enforcement division for approximately \$11.3 million, amounting to a net gain to the Company of approximately \$4.5 million. This business had previously been reported as a separate segment in our financial statements. For the fiscal years ended 2010 and 2009, \$0.3 million, and \$2.9 million of operating income, respectively, net of tax, were reflected as discontinued operations in the accompanying consolidated statements of operations. Net sales associated with the discontinued operations were \$0.5 million, and \$8.6 million for 2010 and 2009, respectively. See "Note B — Discontinued Operations" for further discussion.

LIQUIDITY AND CAPITAL RESOURCES

OPERATING ACTIVITIES OVERVIEW

Net cash used for operations during the year ended December 31, 2010 was approximately \$313,000. The cash used by operating activities of continuing operations was primarily used to fund the operating loss for the year. Other items of note were as follows:

- Negative cash flows related to a decrease in accounts payable and accrued liabilities of approximately \$160,000, and \$78,000, respectively (net outflow of \$238,000),
- Positive cash flows related to an decrease in accounts receivable of approximately \$496,000.

The following non-cash items reflected in the Company's statement of operations are used to reconcile the net loss to the net cash used in operating activities during the year ended December 31, 2010:

- The Company issued notes in 2005, 2006, and 2009 and preferred stock in 2009, all of which contained embedded derivatives, and associated warrants. In 2010, the Company recognized gains of approximately \$1,020,000 related to the decrease in value of the derivatives and associated warrants, offset by amortization of discounts of approximately \$659,000 (net gain of \$361,000).
- The Company recorded approximately \$46,000 of charges in 2010 for the expense of issuing options to employees for services.

INVESTING ACTIVITIES OVERVIEW

Net cash provided by investing activities for the year ended December 31, 2010 was approximately \$31,000. The cash provided by investing activities for continuing operations was primarily driven by the proceeds received from the release of the Company's security deposit over its previous premises.

FINANCING ACTIVITIES OVERVIEW

Net cash provided by financing activities for the year ended December 31, 2010 was \$500,000. The cash provided by financing activities of continuing operations was due to the initial installment payment against the \$4 million note from the sale of the Company's Law division in December 2009.

Net working capital at December 31, 2010 was approximately \$88,000 as compared to approximately \$868,000 at December 31, 2009. The change was due to the Company's restructuring of its balance sheet by exchanging Preferred Stock and Convertible Notes for Secured Notes in December 2010.

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

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

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

Liquidity outlook

At December 31, 2010, our total of cash and cash equivalents was approximately \$1,010,000, as compared to approximately \$792,000 at December 31, 2009.

As discussed above, the Company has financed itself in the past through access to the capital markets by issuing secured and convertible debt securities, as well as convertible preferred stock and common stock. We currently require approximately \$400,000 per month to conduct our operations. During 2010, we generated approximately \$3,500,000 of revenue. While the Company expects to increase revenue in 2011, there can be no assurance that we will achieve that goal.

The Company expects to receive \$3.5 million from the maker of its Note Receivable in periodic installments concluding December 2012. These cash inflows are expected to be offset by amounts due for repayment of the outstanding balance of \$3.2 million of the Company's Secured Promissory Notes issued from the exchange 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.

If we are unable to generate sufficient revenue to meet our goals, or if there is a delay or default in the repayment of the outstanding balance of the Company's secured notes, 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 opinions they have previously issued related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. 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.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements that have, or are in the opinion of management reasonably likely to have, a current or future effect on our financial condition or results of operations. During 2008, the Company extended its property lease at the Marlborough, MA location. Pursuant to the agreement BIO-key was to maintain a security deposit in the form of an irrevocable letter of credit in the amount of \$40,500. However, BIO-key and the landlord for the property subsequently agreed to have BIO-key place the funds in a third party escrow account, to be returned at the conclusion of the lease term, in August 2011. Pursuant to the sale of the Company's Law Enforcement Business to InterAct911 in December 2009 (see "Note B — Discontinued Operations"), the Company is no longer situated at this location, and in June 2010 assigned its obligations under the lease to InterAct911.

CRITICAL ACCOUNTING POLICIES

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. We evaluate our estimates and assumptions on an ongoing basis. Our actual results may differ significantly from these estimates under different assumptions or conditions. There have been no material changes to these estimates for the periods presented in this Annual Report on Form 10-K.

We believe that of our significant accounting policies, which are described in Note A of the notes to our consolidated financial statements included in this Annual Report on Form 10-K, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our financial condition and results of operations.

1. Revenue Recognition

Revenues from software licensing are recognized in accordance with ASC 985-605, "Software Revenue Recognition. Accordingly, revenue from software licensing is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is probable.

The Company intends to enter into arrangements with end users for items which may include software license fees, and services or various combinations thereof. For each arrangement, revenues will be recognized when evidence of an agreement has been documented, the fees are fixed or determinable, collection of fees is probable, delivery of the product has occurred and no other significant obligations remain.

Multiple-Element Arrangements: For multiple-element arrangements, the Company applies the residual method in accordance with ASC 985-605. The residual method requires that the portion of the total arrangement fee attributable to the undelivered elements be deferred based on its VSOE of fair value and subsequently recognized as the service is delivered. The difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements, which is generally the software license. VSOE of fair value for all elements in an arrangement is based upon the normal pricing for those products and services when sold separately. VSOE of fair value for support services is additionally determined by the renewal rate in customer contracts. The Company has established VSOE of fair value for support as well as consulting services.

License Revenues: Amounts allocated to license revenues are recognized at the time of delivery of the software and all other revenue recognition criteria discussed above have been met.

Revenue from licensing software, which requires significant customization and modification, is recognized using the percentage of completion method, based on the hours of effort incurred by the company in relation to the total estimated hours to complete. In instances where third party hardware, software or services form a significant portion of a customer's contract, the company recognizes revenue for the element of software customization by the percentage of completion method described above. Otherwise, third party hardware, software, and services are recognized upon shipment or acceptance as appropriate. If the company makes different judgments or utilizes different estimates of the total amount of work expected to be required to customize or modify the software, the timing and revenue recognition, from period to period, and the margins on the project in the reporting period, may differ materially from amounts reported. Anticipated contract losses are recognized as soon as they become known and are estimable.

Service Revenues: Revenues from services are comprised of maintenance and consulting and implementation services. Maintenance revenues include providing for unspecified when-and-if available product updates and customer telephone support services, and are recognized ratably over the term of the service period. Consulting services are generally sold on a time-and-materials basis and include a range of services including installation of software and assisting in the design of interfaces to allow the software to operate in customized environments. Services are generally separable from other elements under the arrangement since performance of the services are not essential to the functionality of any other element of the transaction and are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services. Revenues from services are generally recognized as the services are performed.

The Company provides customers, free of charge or at a minimal cost, testing kits which potential licensing customers may use to test compatibility/acceptance of the Company's technology with the customer's intended applications.

Costs and other expenses: Includes professional compensation and other direct contract expenses, as well as costs attributable to the support of client service professional staff, depreciation and amortization costs related to assets used in revenue-generating activities, and other costs attributable to serving the Company's client base. Professional compensation consists of payroll costs and related benefits including stock-based compensation and bonuses. Other direct contract expenses include costs directly attributable to client engagements, such as out-of-pocket costs including travel and subsistence for client service professional staff, costs of hardware and software and costs of subcontractors. The allocation of lease and facilities charges for occupied offices are included in costs of service.

2. Derivative and Warrant financial instruments

In connection with the sale of debt or equity instruments, we may sell options or warrants to purchase our common stock. In certain circumstances, these options or warrants may be classified as derivative liabilities, rather than as equity. Additionally, the debt or equity instruments may contain embedded derivative instruments, such as conversion options, which in certain circumstances may be required to be bifurcated from the associated host instrument and accounted for separately as a derivative instrument asset or liability.

Our derivative instrument liability is re-valued at the end of each reporting period, with changes in the fair value of the derivative liability recorded as charges or credits to income, in the period in which the changes occur. For options, warrants and bifurcated conversion options that are accounted for as derivative instrument liabilities, we determine the fair value of these instruments using the Black-Scholes or Binomial option pricing model. That model requires assumptions related to the remaining term of the instruments and risk-free rates of return, our current common stock price and expected dividend yield, and the expected volatility of our common stock price over the life of the option. The identification of, and accounting for, derivative instruments and the assumptions used to value them can significantly affect our financial statements.

3. Impairment or Disposal of Long Lived Assets, including Intangible Assets

We review our long-lived assets, including intangible assets subject to amortization, whenever events or changes in circumstances indicate that the carrying amount of such an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to the future undiscounted cash flows the assets are expected to generate. If such assets are considered impaired, the impairment to be recognized is equal to the amount by which the carrying value of the assets exceeds their fair value determined by either a quoted market price, if any, or a value determined by utilizing a discounted cash flow technique. In assessing recoverability, we must make assumptions regarding estimated future cash flows and discount factors. If these estimates or related assumptions change in the future, we may be required to record impairment charges. Intangible assets with determinable lives are amortized over their estimated useful lives, based upon the pattern in which the expected benefits will be realized, or on a straight-line basis, whichever is greater. We did not record any impairment charges in any of the years presented.

4. Research and Development Expenditures

Research and development expenses include costs directly attributable to the conduct of research and development programs primarily related to the development of our software products and improving the efficiency and capabilities of our existing software. Such costs include salaries, payroll taxes, employee benefit costs, materials, supplies, depreciation on research equipment, services provided by outside contractors, and the allocable portions of facility costs, such as rent, utilities, insurance, repairs and maintenance, depreciation and general support services. All costs associated with research and development are expensed as incurred.

5. Income Taxes

The provision for, or benefit from, income taxes includes deferred taxes resulting from the temporary differences in income for financial and tax purposes using the liability method. Such temporary differences result primarily from the differences in the carrying value of assets and liabilities. Future realization of deferred income tax assets requires sufficient taxable income within the carryback, carryforward period available under tax law. The Company evaluates, on a quarterly basis whether, based on all available evidence, if it is probable that the deferred income tax assets are realizable. Valuation

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allowances are established when it is more likely than not that the tax benefit of the deferred tax asset will not be realized. The evaluation, as prescribed by ASC 740-10, "Income Taxes," includes the consideration of all available evidence, both positive and negative, regarding historical operating results including recent years with reported losses, the estimated timing of future reversals of existing taxable temporary differences, estimated future taxable income exclusive of reversing temporary differences and carryforwards, and potential tax planning strategies which may be employed to prevent an operating loss or tax credit carryforward from expiring unused. Because of the Companies historical performance and estimated future taxable income a full valuation allowance has been established.

6. Accounting for Stock-Based Compensation

The Company accounts for share based compensation in accordance with the provisions of ASC 718-10, "Compensation — Stock Compensation," which requires measurement of compensation cost for all stock awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The majority of our share-based compensation arrangements vest over either a three or four year vesting schedule. The Company expenses its share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant. The fair value of stock options is determined using the Black-Scholes valuation model, and requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (the "expected option term"), the estimated volatility of our common stock price over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield. Changes in these subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized as an expense in the consolidated statements of operations. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, are likely to change our valuation assumptions used to value employee stock-based awards granted in future periods.

The values derived from using the Black-Scholes model are recognized as expense over the service period, net of estimated forfeitures (the number of individuals that will ultimately not complete their vesting requirements). The estimation of stock awards that will ultimately vest requires significant judgment. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

RECENT ACCOUNTING STANDARDS

In July 2010, the FASB issued Accounting Standards Update 2010-20, "Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The adoption of ASU 2010-20 did not have a significant impact on its consolidated financial statements.

In April 2010, the FASB issued ASU 2010-17 (ASU 2010-17), "Revenue Recognition-Milestone Method (Topic 605): Milestone Method of Revenue Recognition." The amendments in this Update are effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. Early adoption is permitted. If a vendor elects early adoption and the period of adoption is not the beginning of the entity's fiscal year, the entity should apply the amendments retrospectively from the beginning of the year of adoption. The Company will adopt this standard effective January 1, 2011. The Company does not expect the provisions of ASU 2010-17 to have a material effect on the financial position, results of operations or cash flows of the Company.

In September 2009, the FASB issued ASU 2009-13, *Multiple Element Arrangements*. ASU 2009-13 addresses the determination of when the individual deliverables included in a multiple arrangement may be treated as separate units of accounting. ASU 2009-13 also modifies the manner in which the transaction consideration is allocated across separately identified deliverables and establishes definitions for determining fair value of elements in an arrangement. This standard must be adopted by the Company no later than January 1, 2011 with earlier adoption permitted. The Company will adopt this

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standard effective January 1, 2011. The Company is currently evaluating the impact, if any, that this standard update will have on its consolidated financial statements.

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.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

N/A

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

See financial statements appearing at pages 39-67 of this report

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

N/A

ITEM 9A. 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 December 31, 2010. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of December 31, 2010, our CEO and CFO concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, the risk. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures

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may deteriorate.

Under the supervision and with the participation of our management, including our CEO and CFO, we have conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2010, based upon the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management has concluded that our internal control over financial reporting was effective as of December 31, 2010.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

Changes in Internal Control Over Financial Reporting

No change in our internal control over financial reporting occurred during the fiscal quarter ended December 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The following sets forth certain information about each director and executive officer of the Company.

NAME	AGE	POSITIONS HELD
Thomas J. Colatosti	62	Chairman of the Board of Directors
Michael W. DePasquale	56	Chief Executive Officer and Director
Jeffrey J. May (b)	51	Director
Charles P. Romeo (a) (c)	69	Director
John Schoenherr (b) (c)	58	Director
Cecilia Welch	51	Chief Financial Officer
Randy Fodero	52	Vice President of Sales
Mira K. LaCous	49	Vice President of Technology & Development
Scott Mahnken	51	Vice President of Marketing

(a) From April 2004 to February 2005, Mr. Romeo was employed by the Company.

(b) Audit Committee Member

(c) Compensation Committee Member

The following is a brief summary of the business experience of each of the above-named individuals:

THOMAS J. COLATOSTI has served as a Director of the Company since September 2002, as Chairman of the Board since January 3, 2003, and as Chief Financial Officer from November 17, 2008 to December 21, 2009. Mr. Colatosti also served as Co-Chief Executive Officer of the Company from July 2005 to August 2006. Mr. Colatosti also currently serves as the Chief Executive Officer of American Security Ventures, a

Lexington, Massachusetts-based consulting firm he founded which specializes in providing strategic management services to emerging and developing companies in the homeland security industry. Since November 2010, Mr. Colatosti has been serving as a President and CEO of Oasis Systems LLC, a privately held IT services company. Since August 2009, Mr. Colatosti has served as Chairman of Commodore Advanced Sciences Corporation a non-reporting environmental services and remediation company. From August 18, 2005 until August 18, 2008 Mr. Colatosti served as Director and President of Good Harbor Partners Acquisition Corp., a publicly-traded special purpose acquisition company formed to acquire businesses in the security sectors. From 1997 through June 2002, Mr. Colatosti served as the Chief Executive Officer of Viisage Technology, Inc., a publicly traded biometric technology company. Between 1995 and 1997, Mr. Colatosti served as President and Chief Executive Officer of CIS Corporation. Prior to CIS, Mr. Colatosti had a 21 year career with Digital Equipment Corporation. Among his executive positions he was Vice President and General Manager of the company's \$1.2 billion Government Systems Division.

MICHAEL W. DEPASQUALE has served as the Chief Executive Officer and a Director of the Company since January 3, 2003. He served as Co-Chief Executive Officer of the Company from July 2005 to August 2006. Mr. DePasquale brings more than 27 years of executive management, sales and marketing experience to the Company. Prior to joining BIO-key, Mr. DePasquale served as the President and Chief Executive Officer of Prism eSolutions, Inc., a Pennsylvania-based provider of professional consulting services and online solutions for ISO-9001/14000 certification for customers in manufacturing, healthcare and government markets, since February 2001. From December 1999 through December 2000, Mr. DePasquale served as Group Vice President for WRC Media, a New York-based distributor of supplemental education products and software. From January 1996 until December 1999, Mr. DePasquale served as Senior Vice President of Jostens Learning Corp., a California-based provider of multi media curriculum. Prior to Jostens, Mr. DePasquale held sales and marketing management positions with McGraw-Hill and Digital Equipment Corporation. Mr. DePasquale earned a Bachelor of Science degree from the New Jersey Institute of Technology. He serves on the Board of Directors of the International Biometrics and Identification Industry Association.

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JEFFREY J. MAY has served as a Director of the Company since October 29, 2001. Since December 2006, Mr. May has served as the CEO and Director of MagnaLynx, a semiconductor company specializing in high speed chip level communications. Since 1997, Mr. May has served as the President of Gideons Point Capital, a Minnesota-based investment and consulting firm focusing on assisting start-up technology companies. In 1983, Mr. May co-founded Advantek, Inc., a manufacturer of equipment and materials for the semiconductor industry, which was sold in 1993. Mr. May continued to serve as a director and Vice-President of Operations of Advantek until 1997, when it had over 600 employees and sales in excess of \$100 million. Mr. May earned a Bachelor of Science degree in Electrical Engineering from the University of Minnesota in 1983.

CHARLES P. ROMEO has served as a director of the Company since February 28, 2005 and from January 29, 2003 to April 19, 2004. From April 2004 until February 2005, he served as Vice President of Sales, Public Safety Division of the Company. From November 2005 to November 2007, Mr. Romeo served as the Vice President of Sales and Marketing for UNICOM, a Rhode Island systems integrator. From September 2002 until April 2004 Mr. Romeo has served as the President and Chief Executive Officer of FreedomBridge Technologies, Inc., a Rhode Island-based consulting firm to technology companies in the homeland security industry specializing in implementing direct and channel selling programs, strategic alliances and partnerships in the law enforcement market. Prior to founding FreedomBridge, Mr. Romeo had a 33 year sales and marketing management career with Digital Equipment Corporation, Compaq Computer Corporation and Hewlett Packard. During his career, Mr. Romeo served as Vice President of Service Sales for a \$500 million business unit, and Director of Public Sector Sales, a \$275 million division of Hewlett Packard. Mr. Romeo authored *The Sales Manager's Troubleshooter*, Prentice Hall 1998, which was named as one of the "top 10 must reads" by Sales and Marketing Magazine. Mr. Romeo earned a Bachelor of Science degree in Mathematics and Economics from the University of Massachusetts and an Executive MBA from Babson College.

JOHN SCHOENHERR has served as a Director of the Company since December 30, 2004. Mr. Schoenherr served as Vice President of Corporate Performance Management for Oracle Corporation from 1995 through 2006. Prior to Oracle he served as Senior Vice President of Business Intelligence and Analytics at Information Resources, Inc. Mr. Schoenherr has over 25 years of experience in the area of business intelligence and strategic planning. His career includes a number of product development and management positions.

CECILIA WELCH has served as Chief Financial Officer of the Company since December 21, 2009. Ms. Welch joined the Company in 2007 and has served since then as the Company's Corporate Controller. Prior to joining the Company, from January 2006 to December 2006 she was the Controller for Savaje Technologies (acquired by Sun Microsystems), a developer of advanced mobile telephone software. From October 2004 to January 2006, she was Controller for Crystal Systems, a manufacturer of sapphire crystals used for industrial, semiconductor, defense and medical applications. From December 1988 to July 2004, she was the Controller for ATN Microwave (acquired by Agilent Technologies), a manufacturer of automated test equipment. Ms. Welch has a Bachelor's degree in Accounting from Franklin Pierce University.

RANDY FODERO has served as the Vice President of Sales since March 2003. Mr. Fodero has more than 20 years of successful executive and sales management experience. Prior to joining the Company, Mr. Fodero served as Director of Global Accounts for Veritas Software from February 2002 until January 2003. Between 1999 and February 2002, Mr. Fodero served in executive sales capacities with companies in the enterprise software industry, including Agile Software, and Memco Software. At Memco Software, a leading provider of information security software to Fortune 1000 companies, he was instrumental in increasing sales and enhancing shareholder value in connection with the sale of Memco to Platinum Technology. From 1990 through 1998, Mr. Fodero served as Vice President of Sales of CommVault Systems, where he grew sales from startup to over \$36 million and participated in a management buyout.

MIRA K. LACOUS has served as Vice President of Technology & Development of the Company since May 15, 2000. Ms. LaCous has over 27 years of product / project management, solution architecture, software development, team leadership and customer relations experience with a background that includes successfully bringing numerous technologies to market, including automated voice response systems, automated building control systems, software piracy protection, intranet training materials and testing, page layout and design software, image scanning

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University. Ms. LaCous also serves on the Board of Directors of the Minnesota Sinfonia, a not-for-profit arts and education organization, as its chairperson emeritus.

SCOTT MAHNKEN has served as Vice President of Marketing since February 2011. He brings over 20 years of marketing experience and success through strategic marketing and building dynamic relationships with channel partners. Prior to joining the Company, from August 2009 until February 2011 he was President of Edge Marketing, a leading marketing consulting firm in the dental and medical devices industries. From February 2008 until August 2009, Mr. Mahnken served as Director of Marketing at Milestone Scientific Inc, a manufacturer of computer controlled anesthetic delivery medical devices. From August 2002 until January 2008, he served as Director of Partnership Relations at ArcMesa Educators, an organization dedicated to providing accredited continuing education to medical and dental providers. Prior to ArcMesa, Mr. Mahnken held a number of marketing roles with the Lanmark Group a leading healthcare advertising agency. Mr. Mahnken is a graduate of the University of New Orleans, where he earned a Bachelors of Art degree in Marketing.

Directors' Terms of Office

Mr. May was initially elected to serve as a director in 2001, and was re-elected in 2004. Mr. Colatosti was initially elected to serve as a director in 2002, and was re-elected in 2004. Mr. DePasquale was initially elected as a director in 2003, and was re-elected in 2004. Mr. Schoenherr was initially elected as a director in 2004. Mr. Romeo was initially elected as a director in 2005. Each such director was elected to serve until the Company's next annual meeting or until his successor is duly elected and qualified in accordance with the By-laws of the Company.

Audit Committee

The Audit Committee is comprised of John Schoenherr and Jeffrey J. May, who may not qualify as "audit committee financial experts" under the applicable rules adopted by the Securities and Exchange Commission. However, the Board believes that each Audit Committee member has sufficient knowledge in financial and auditing matters to serve on the Audit Committee. Additionally, the Audit Committee has the ability on its own to retain independent accountants or consultants whenever it deems appropriate.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the U.S. Securities and Exchange Act of 1934, as amended (the "Exchange Act"), requires the Company's officers and directors and persons who own more than ten percent (10%) of the Company's Common Stock to file with the Securities and Exchange Commission ("SEC") initial reports of ownership and reports of changes in ownership of the Company's Common Stock. Such officers, directors and ten percent (10%) stockholders are also required by applicable SEC rules to furnish the Company with copies of all forms filed with the SEC pursuant to Section 16(a) of the Exchange Act. Based solely on its review of the copies of such forms received by it, or written representations from such persons that no other reports were required for such persons, the Company believes that during the fiscal year ended December 31, 2010, all Section 16(a) filing requirements applicable to the Company's officers, directors and ten percent (10%) stockholders were satisfied in a timely fashion.

Code of Ethics

We have adopted a Code of Ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. Our Code of Ethics is designed to deter wrongdoing and promote: (i) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (ii) full, fair, accurate, timely and understandable disclosure in reports and documents that we file with, or submit to, the SEC and in our other public communications; (iii) compliance with applicable

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governmental laws, rules, and regulations; (iv) the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (v) accountability for adherence to the code. Any person may obtain a copy of our Code of Ethics free of charge by sending a written request for such to the attention of the Chief Financial Officer of the Company, 3349 Highway 138, Building D Suite B, Wall, NJ 07719.

Internet Address and SEC Reports

We maintain a website with the address www.BIO-key.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. We make available free of charge through our website our Annual Reports

on Form 10-K (and, where applicable, 10-KSB), Quarterly Reports on Form 10-Q (and, where applicable, 10-QSB) and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the SEC. Our SEC filings are also available over the Internet at the SEC's website www.sec.gov. Members of the public may read and copy any materials the Company files with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the public reference room is available by calling the SEC on 1800-SEC-0330.

ITEM 11. EXECUTIVE COMPENSATION

The following table sets forth a summary of the compensation paid to or accrued by our chief executive officer (principal executive officer) and the two most highly compensated executive officers other than the principal executive officer, who were serving as executive officers at the end of December 31, 2010, for the fiscal years ended December 31, 2010 and 2009:

SUMMARY COMPENSATION TABLE

Name	Fiscal Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
Michael W. DePasquale Chief Executive Officer	2010	250,000	—	—	—	—	—	407	250,407
	2009	250,000	—	—	93,976(1)	—	—	425	344,401
Randy Fodero Vice President Sales	2010	170,000	4,000	—	—	37,560	—	289	211,849
	2009	170,000	—	—	34,938(1)	35,339	—	300	240,577
Mira K. LaCous Vice President Technology & Development	2010	147,420	—	—	67,974(1)	—	—	251	215,645
	2009	145,665	—	—	—	—	—	248	145,913

(1) The aggregate grant date fair value of the option awards was estimated using the Black-Scholes option pricing model, with the assumptions listed in Note A to the Company's financial statements. The amount shown in this column represents the grant date fair value calculated under ASC 718

Narrative Disclosure to Summary Compensation Table

Compensation for BIO-key's executives is comprised of three main components: base salary, annual performance-based cash bonus and long-term equity awards. We do not target a specific weighting of these three components or use a prescribed formula to establish pay levels. Rather, the board of directors and compensation committee considers changes in the business, external market factors and our financial position each year when determining pay levels and allocating between long-term and current compensation for the named executive officers.

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Cash compensation is comprised of base salary and an annual performance-based cash bonus opportunity. The committee generally seeks to set a named executive officer's targeted total cash compensation opportunity within a range that is the average of the applicable peer company and/or general industry compensation survey data, adjusted as appropriate for individual performance and internal pay equity and labor market conditions.

In setting cash compensation levels, we favor a balance in which base salaries are generally targeted at slightly below the peer average and a bonus opportunity that is targeted at slightly above the average. The committee believes that this higher emphasis on performance-based cash bonuses places an appropriate linkage between a named executive officer's pay, his or her individual performance and the achievement of specific business goals by placing a higher proportion of annual cash compensation at risk, thereby aligning executive opportunity with the interests of stockholders.

We include an equity component as part of our compensation package because we believe that equity-based compensation aligns the long-term interests of our named executive officers with those of stockholders.

These cash and equity compensation components of pay are supplemented by various benefit plans that provide health, life, accident, disability and severance benefits, most of which are the same as the benefits provided to all of our US based employees.

Employment Agreements

On March 26, 2010, the Company entered into an employment agreement, effective as of March 25, 2010, with Michael W. DePasquale to serve as the Chief Executive Officer of the Company until March, 24, 2011. The agreement automatically renews for subsequent one-year terms, unless the employment relationship is terminated by either party, or modified in accordance with the terms and conditions of the Agreement. Under the Agreement, Mr. DePasquale will be paid an annual base salary of \$250,000, subject to adjustment by the Board or Compensation Committee. In addition to the Base Salary, a "Performance Bonus" may be awarded to Mr. DePasquale on the basis of the Company achieving certain corporate and strategic performance goals, as determined by the Board in its sole discretion. The employment agreement contains

standard and customary confidentiality, non-solicitation and "work made for hire" provisions as well as a covenant not to compete which prohibits Mr. DePasquale from doing business with any current or prospective customer of the Company or engaging in a business competitive with that of the Company during the term of his employment and for the one year period thereafter. This agreement also contains a number of termination and change in control provisions as described in "Termination and Change in Control Arrangements" in this Item.

On November 20, 2010, the Company renewed its one-year employment agreement with Mira K. LaCous to serve as the Vice President of Technology & Development of the Company at an annual base salary of \$147,420, subject to adjustment by the Board or Compensation Committee. The employment agreement contains standard and customary confidentiality, technical invention provisions, as well as a covenant not to compete which prohibits Ms. LaCous from doing business with any current or prospective customer of the Company or engaging in a business competitive with that of the Company during the term of her employment and for the one year period thereafter. This agreement also contains a number of termination provisions as described in "Termination and Change in Control Arrangements" in this Item.

Stock Option Grants

In the event of any change in the outstanding shares of our common stock by reason of a stock dividend, stock split, combination of shares, recapitalization, merger, consolidation, transfer of assets, reorganization, conversion or what the board deems to be similar circumstances, the number and kind of shares subject to outstanding options, and the exercise price of such options shall be appropriately adjusted in a manner to be determined in the sole discretion of the board. Furthermore, these option agreements contain a change of control provision as described in "Termination Arrangements" in this Item.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR END DECEMBER 31, 2010

The following table sets forth for each named executive officer, information regarding outstanding equity awards as at

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December 31, 2010:

Name	Option Awards					Stock Awards			
	Number of securities underlying unexercised options exercisable (#)	Number of securities underlying unexercised options unexercisable (#)	Equity incentive plan awards: Number of securities underlying unexercised options (#)	Option exercise price (\$)	Option expiration date	Number of shares or units of stock that have not vested (#)	Market value of shares or units of stock that have not vested (\$)	Equity incentive awards: Number of unearned shares or units or other rights that have not vested (#)	Equity incentive plan awards: Market or payout value of unearned shares, units or other rights that have not vested (\$)
Michael W. DePasquale	500,000	—	—	0.087	2/27/2016	—	—	—	—
	601,938	—	—	0.300	11/2/2012	—	—	—	—
Randy Fodero	340,000	—	—	0.300	11/2/2012	—	—	—	—
Mira LaCous	75,000	—	—	0.180	8/13/2015	—	—	—	—
	—(1)	340,000(1)	—	0.460	1/7/2017	—	—	—	—

(1) The options vest equally in two annual installments commencing January 7, 2011

Narrative Disclosure to Outstanding Equity Awards at Fiscal Year End Table

The following are the material terms of each agreement, contract, plan or arrangement that provide for payments to one or more of our named executive officers at, following or pursuant to their resignation, retirement or termination, or in connection with a change in control of the Company.

Termination Arrangements

On January 12, 2010, the Company entered into a two-year consulting agreement with Thomas Colatosti to serve as consultant to the Company. The Company may terminate the agreement at any time with or without cause. In the event of termination by the Company without cause, Mr. Colatosti shall continue to be paid his then current base salary for the remaining term of the agreement.

- (1) Refer to Narrative Disclosure To Director Compensation Table for information pertaining to Mr. Colatosti's consulting agreement.
- (2) Refer to Narrative Disclosure To Summary Compensation Table for information pertaining to Mr. DePasquale's employment agreement.
- (3) The aggregate grant date fair value of the option awards was estimated using the Black-Scholes option pricing model, with the assumptions listed in Note A to the Company's financial statements. The amount shown in this column represents the grant date fair value calculated under ASC 718
- (4) The aggregate number of stock and option awards outstanding at December 31, 2010 for each of the Company's directors are the same amounts as are listed in Item 12 "Security Ownership Of Certain Beneficial Owners And Management And Related Stockholder Matters" as at February 15, 2011.

Narrative Disclosure to Director Compensation Table

The Company's current policy is to issue options to purchase 50,000 shares of common stock to each non-employee director on an annual basis. The Chair of the Audit Committee receives options to purchase an additional 50,000 shares of common stock on an annual basis. No options were awarded to any of the Company's directors during 2010.

In connection with his appointment to the Board of Directors in September 2002, and as acting Chief Financial Officer from November 2008 to December 2009, the Company has entered into a number of consulting arrangements with Thomas Colatosti. Under the most recent arrangement, which was entered into on January 12, 2010, Mr. Colatosti is to provide services to the Company and its subsidiaries and affiliates for a two year term ending December 31, 2011 at a rate of \$5,000 per month.

We reimburse each of our non-employee directors for their reasonable expenses incurred in connection with attending meetings of the board of directors and related committees.

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ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth, as of February 15, 2011, information with respect to the securities holdings of all persons which the Company, pursuant to filings with the Securities and Exchange Commission, has reason to believe may be deemed the beneficial owners of more than five percent (5%) of the Company's outstanding common stock. The following table also sets forth, as of such date, the beneficial ownership of the Company's common stock by all officers and directors, individually and as a group. Unless otherwise indicated, the address of each person listed below is c/o BIO-key International, Inc., 3349 Highway 138, Building D, Suite B, Wall, NJ 07719.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership(1)	Percentage of Class(1)
Michael W. DePasquale	1,101,938(2)	1.4%
Thomas J. Colatosti	759,405(4)	1.0%
Randy Fodero	340,000(2)	*
Jeffrey May	316,845(2)	*
Mira LaCous	245,000(3)	*
Charles P. Romeo	233,558(2)	*
John Schoenherr	209,721(2)	*
Cecilia Welch	20,000(2)	*
Scott Mahnken	—	*
All officers and directors as a group (9) persons	3,226,467	4.1%

* Less than 1%

- (1) The securities "beneficially owned" by an individual are determined in accordance with the definition of "beneficial ownership" set forth in the regulations promulgated under the Securities Exchange Act of 1934 and, accordingly, may include securities owned by or for, among others, the spouse and/or minor children of an individual and any other relative who has the same home as such individual, as well as, other securities as to which the individual has or shares voting or investment power or which each person has the right to acquire within 60 days through the exercise of options or otherwise. Beneficial ownership may be disclaimed as to certain of the securities. This table has been prepared based on 78,155,413 shares of common stock outstanding as of February 15, 2011.
- (2) Consists of shares issuable upon exercise of options.
- (3) Consists of 245,000 shares issuable upon exercise of options. Does not include 170,000 shares issuable upon options subject to vesting.

(4) Consists of 549,405 shares issuable upon exercise of options and 210,000 shares of common stock.

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The following table sets forth, as of December 31, 2010, information with respect to securities authorized for issuance under equity compensation plans.

EQUITY COMPENSATION PLAN INFORMATION

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	—	—	—
Equity compensation plans not approved by security holders	4,410,530	\$ 0.25	1,419,311
Total	4,410,530	\$ 0.25	1,419,311

During 1996, the Board of Directors and stockholders of the Company adopted the 1996 Stock Option Plan (the 1996 Plan). Under the 1996 Plan, 750,000 shares of common stock were reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 100% of fair market value for incentive stock options and 50% for all others. The term of stock options granted may not exceed ten years. Options issued under the Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The 1996 Plan expired in May 2005.

As of December 31, 2010, there were no outstanding options under the 1996 Plan to purchase shares of common stock, and no shares were available for future grants.

The Company's 1999 Stock Option Plan (the "1999 Plan") was adopted by the Board of Directors of the Company on or about August 31, 1999. The material terms of the 1999 Plan are summarized below.

The 1999 Plan is currently administered by the Board of Directors of the Company (the "Plan Administrator"). The Plan Administrator is authorized to construe the 1999 Plan and any option issued under the 1999 Plan, select the persons to whom options may be granted, and determine the number of shares to be covered by any option, the exercise price, vesting schedule and other material terms of such option. Under the 1999 Plan 2,000,000 shares of common stock were reserved for issuance to officers, employees, directors and consultants of the Company at exercise prices not less than 85% of the last sale price of the Company's common stock as reported on the OTC Bulletin Board on the date of grant. Options have terms of not more than 10 years from the date of grant, are subject to vesting as determined by the Plan Administrator and are not transferable without the permission of the Company except by will or the laws of descent and distribution or pursuant to a domestic relations order. Options terminate three (3) months after termination of employment or other association with the Company or one (1) year after termination due to disability, death or retirement. In the event that termination of employment or association is for a cause, as that term is defined in the 1999 Plan, options terminate immediately upon such termination. The Plan Administrator has the discretion to extend options for up to three years from the date of termination or disassociation with the Company.

The 1999 Plan provides for the immediate vesting of all options in the event of a "Change In Control" of the Company. In the event of a Change In Control, the Company is required to deliver written notice to each optionee under the 1999 Plan fifteen (15) days prior to the occurrence of a Change in Control, during which time all options issued under 1999 Plan may be exercised. Thereafter, all options issued under the 1999 Plan which are neither assumed or substituted in connection with such transaction, automatically expire, unless otherwise determined by the Board. Under the 1999 Plan, a "Change In Control" is defined to include (i) a sale or transfer of substantially all of the Company's assets; (ii) the dissolution or liquidation of the Company; (iii) a merger or consolidation to which the Company is a party and after which the prior shareholders of the Company hold less than 50% of the combined voting power of the surviving corporation's outstanding securities; (iv) the incumbent directors cease to constitute at least a majority of the Board of Directors; or (v) a change in control of the Company which would otherwise be reportable under Section 13 or 15(d) of the Exchange Act. The 1999 Plan expired in August 2009.

As of December 31, 2010, there were outstanding options under the 1999 Plan to purchase 500,000 shares of common

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stock, and no shares were available for future grants.

On October 12, 2004, the Board of Directors of the Company approved the 2004 Stock Option Plan (the 2004 Plan). The 2004 Plan has not

yet been presented to stockholders for approval and thus incentive stock options are not available under this plan. Under the terms of this plan, 4,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of stock options granted may not exceed ten years. Options issued under the 2004 Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The 2004 Plan expires in October 2014.

As of December 31, 2010, there were outstanding options under the 2004 Plan to purchase 2,580,689 shares of common stock, and options to purchase an aggregate of 1,419,311 shares were available for future grants.

In addition to options issued under the 1996, 1999 and 2004 Plans, the Company has issued options to employees, officers, directors and consultants to purchase common stock under the non plan. As of December 2009, there were outstanding options under the non plan to purchase 1,329,841 shares of common stock. The terms of these options are substantially similar to the provisions of the 1999 Plan and options issued thereunder.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Employment Arrangements

The Company has entered into employment agreements with Michael W. DePasquale, and Mira LaCous. See **EXECUTIVE COMPENSATION—Employment Agreements.**

Consulting Arrangement with Thomas J. Colatosti

In connection with his appointment to the Board of Directors in September 2002, and as acting Chief Financial Officer from November 2008 to December 2009, the Company has entered into a number of consulting arrangements with Thomas Colatosti. Under the most recent arrangement, which was entered into on January 12, 2010, Mr. Colatosti is to provide services to the Company and its subsidiaries and affiliates for a two year term ending December 31, 2011 at a rate of \$5,000 per month.

Director Independence

The Board applies the definition of independent director as set forth in NASDAQ Stock Market Rule 4200 (a)(15), as well as Rule 10A-3 under the Securities Exchange Act of 1934, as amended.

In accordance with this guidance, the Board considers Mr. May, Mr. Schoenherr, and Mr. Romeo to be independent. Mr. May and Mr. Schoenherr are the members of the Company's Audit Committee, while Mr. Schoenherr and Mr. Romeo are the members of the Company's Compensation Committee.

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ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table shows fees for professional audit services billed to us by CCR LLP ("CCR") for the audit of our annual consolidated financial statements for the year ended December 31, 2009, and fees billed to us by CCR for other services during 2010 and 2009, and for professional audit services billed to us by Rotenberg Meril Solomon Bertiger & Guttilla, P.C. ("RMSBG") for the audit of our annual consolidated financial statements for the year ended December 31, 2010, and fees billed to us by RMSBG for other services during 2010:

	2010	2009
Audit Fees:		
CCR	\$ 20,000	\$ 110,500
RMSBG	65,000	—
Audit-Related Fees		
CCR	47,150	20,787
RMSBG	3,048	—
Tax Fees:		
CCR	28,700	41,473
RMSBG	—	—
Total Fees	\$ 163,898	\$ 172,760

Audit Fees consist of fees billed for professional services rendered for the audit of our financial statements and review of the interim financial statements included in quarterly reports and services that are normally provided by our auditors in connection with statutory and regulatory filings or engagements. Audit fees also include fees for services provided in connection with registration of securities, comfort letters, and review of documents filed with the SEC.

Audit-Related Fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements and which are not reported under audit fees. These services relate primarily to mergers and acquisitions due diligence as well as advisory services as it pertains to the Sarbanes-Oxley Act and related rules and regulations;

Tax Fees consist of fees billed for professional services for tax compliance assistance rendered during the fiscal year.

Audit Committee Pre-Approval Procedures

The Audit Committee of our Board of Directors consists of Jeffrey J. May and John Schoenherr. The Audit Committee approves the engagement of our independent auditors to render audit and non-audit services before they are engaged. All of the fees for 2010 and 2009 shown above were pre-approved by the Audit Committee.

The Audit Committee pre-approves all audit and other permitted non-audit services provided by our independent auditors. Pre-approval is generally provided for up to one year, is detailed as to the particular category of services and is subject to a monetary limit. Our independent auditors and senior management periodically report to the Audit Committee the extent of services provided by the independent auditors in accordance with the pre-approval, and the fees for the services performed to date. The Audit Committee may also pre-approve particular services on a case-by-case basis.

Our audit committee will not approve engagements of our independent registered public accounting firm to perform non-audit services for us if doing so will cause our independent registered public accounting firm to cease to be independent within the meaning of applicable SEC rules. In other circumstances, our audit committee considers, among other things,

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whether our independent registered public accounting firm is able to provide the required services in a more or less effective and efficient manner than other available service providers.

ITEM 15. EXHIBITS

(a) The following documents are filed as part of this Report. Portions of Item 15 are submitted as separate sections of this Report:

(1) Financial statements filed as part of this Report:

Reports of Independent Registered Public Accounting Firm

Balance Sheets as at December 31, 2010 and 2009

Statements of Operations—Years ended December 31, 2010 and 2009

Statement of Stockholders' Equity (Deficit)—Years ended December 31, 2010 and 2009

Statements of Cash Flows—Years ended December 31, 2010 and 2009

Notes to Financial Statements—December 31, 2010 and 2009

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

ITEM 8—FINANCIAL STATEMENTS

The following financial statements of BIO-key International, Inc. are included herein at the indicated page numbers:

Report of Independent Registered Public Accounting Firm, RMSBG P.C.	40
Report of Independent Registered Public Accounting Firm, CCR LLP	41
Balance Sheets as at December 31, 2010 and 2009	42
Statements of Operations—Years ended December 31, 2010 and 2009	43
Statement of Stockholders' Equity (Deficit)—Years ended December 31, 2010 and 2009	44
Statements of Cash Flows—Years ended December 31, 2010 and 2009	45
Notes to the Financial Statements—December 31, 2010 and 2009	46

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
BIO-key International, Inc.
North Billerica, MA

We have audited the accompanying consolidated balance sheet of BIO-key International, Inc. and Subsidiary (the "Company") as of December 31, 2010, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management as well as evaluating the overall consolidated financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BIO-key International, Inc. and Subsidiary as of December 31, 2010, and the consolidated results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As disclosed in the consolidated financial statements, the Company has suffered substantial net losses in recent years, and has an accumulated deficit at December 31, 2010, which raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding these matters are disclosed in Note A. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Rotenberg Meril Solomon Bertiger & Guttilla, P.C.

ROTENBERG MERIL SOLOMON BERTIGER & GUTTILLA, P.C.
Saddle Brook, New Jersey
March 23, 2011

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
BIO-key International, Inc.
North Billerica, MA

We have audited the accompanying consolidated balance sheet of BIO-key International, Inc. and Subsidiary as of December 31, 2009, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management as well as evaluating the overall consolidated financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BIO-key International, Inc. and Subsidiary as of December 31, 2009, and the consolidated results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As disclosed in the consolidated financial statements, the Company has suffered substantial net losses in recent years, and has an accumulated deficit at December 31, 2009, which raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding these matters are disclosed in Note A. The consolidated financial statements do not include any adjustments that might result from the

[Table of Contents](#)**BIO-key International, Inc and Subsidiary
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2010	2009
ASSETS		
Cash and cash equivalents	\$ 1,010,096	\$ 792,426
Restricted cash	—	40,500
Accounts receivable, net of allowance for doubtful accounts of \$11,526 at December 31, 2010 and December 31, 2009	351,093	847,215
Note receivable, current portion	2,167,000	1,334,000
Inventory	9,775	14,935
Prepaid expenses and other	188,916	123,911
Total current assets	<u>3,726,880</u>	<u>3,152,987</u>
Equipment and leasehold improvements, net	28,128	39,243
Deposits and other assets	8,712	8,712
Note receivable, net of current portion	1,333,000	2,666,000
Intangible assets—less accumulated amortization	218,450	230,259
Total non-current assets	<u>1,588,290</u>	<u>2,944,214</u>
TOTAL ASSETS	\$ 5,315,170	\$ 6,097,201
LIABILITIES		
Accounts payable	\$ 180,413	\$ 340,241
Accrued liabilities	1,079,117	708,765
Deferred revenue	281,393	200,996
Current portion of notes payable, derivatives and warrants	2,098,139	471,483
Redeemable preferred stock derivatives	—	563,599
Total current liabilities	<u>3,639,062</u>	<u>2,285,084</u>
Warrants	—	63,901
Long term portion of notes payable, derivatives and warrants	1,102,492	—
Deferred revenue, net of current portion	4,281	9,391
Total non-current liabilities	<u>1,106,773</u>	<u>73,292</u>
TOTAL LIABILITIES	4,745,835	2,358,376
Commitments and contingencies		
Series D redeemable convertible preferred stock: authorized, 100,000 shares (liquidation preference of \$100 per share); issued and outstanding 0 and 30,557 shares of \$.0001 par value at December 31, 2010 and December 31, 2009, respectively	—	2,630,593
	—	<u>2,630,593</u>
STOCKHOLDERS' EQUITY:		
Common stock — authorized, 170,000,000 shares; issued and outstanding; 78,155,413 and 77,713,398 of \$.0001 par value at December 31, 2010 and December 31, 2009, respectively	7,815	7,771
Additional paid-in capital	50,955,602	51,187,754
Accumulated deficit	(50,394,082)	(50,087,293)
TOTAL STOCKHOLDERS' EQUITY	<u>569,335</u>	<u>1,108,232</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 5,315,170	\$ 6,097,201

The accompanying notes are an integral part of these statements.

STATEMENTS OF OPERATIONS

	Years ended December 31,	
	2010	2009
Revenues		
Services	\$ 439,759	\$ 482,900
License fees and other	3,080,649	1,874,382
	<u>3,520,408</u>	<u>2,357,282</u>
Costs and other expenses		
Cost of services	102,661	82,594
Cost of license fees and other	456,480	421,641
	<u>559,141</u>	<u>504,235</u>
Gross Profit	<u>2,961,267</u>	<u>1,853,047</u>
Operating expenses		
Selling, general and administrative	3,105,291	3,382,613
Research, development and engineering	1,055,980	927,241
	<u>4,161,271</u>	<u>4,309,854</u>
Operating loss	<u>(1,200,004)</u>	<u>(2,456,807)</u>
Other income (deductions)		
Interest income	241,416	165,707
Interest expense	(711,348)	(75,903)
Derivative and warrant fair value adjustments	1,020,164	(286,492)
Other expense	—	(9,393)
	<u>550,232</u>	<u>(206,081)</u>
Loss from continuing operations	(649,772)	(2,662,888)
Income from discontinued operations	342,983	2,872,535
Gain on disposal of discontinued operations, net of expected tax	—	4,483,902
Net (loss) income	<u>\$ (306,789)</u>	<u>\$ 4,693,549</u>
Loss applicable to common stockholders		
Net loss	(649,772)	(2,662,888)
Convertible preferred stock dividends, accretion and redemption gain	(643,759)	(518,749)
Loss applicable to common stockholders	<u>\$ (1,293,531)</u>	<u>\$ (3,181,637)</u>
Basic and Diluted Earnings per Common Share:		
Loss from continuing operations	\$ (0.02)	\$ (0.04)
Income from discontinued operations	0.01	0.04
Gain on disposal of discontinued operations	—	0.06
Net (loss) income	<u>\$ (0.01)</u>	<u>\$ 0.06</u>
Weighted Average Shares Outstanding:		
Basic and Diluted	77,901,103	72,553,586

The accompanying notes are an integral part of these statements.

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**BIO-key International, Inc. and Subsidiary
STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)**

	Series A 7% Convertible Preferred Stock		Series B 15% Convertible Preferred Stock		Series C 15% Convertible Preferred Stock		Series D 7% Convertible Preferred Stock		Common Stock		Additional Contributed Capital	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount			
Balance as of December 31, 2008	30,557	\$ 3	970,612	\$1,008,224	592,032	\$6,498,516	—	\$ —	67,876,880	\$ 6,788	\$51,692,103	\$(54,780,842)	\$(3,081,948)
Conversion of Series A to Series D Preferred Stock	(30,557)	(3)	—	—	—	—	30,557	3,055,700	—	—	(3,055,697)	—	(3,055,700)

Discount on Preferred Stock	—	—	—	—	—	—	—	(430,398)	—	—	—	—	—	
Accretion of preferred stock discount	—	—	—	—	—	—	—	3,509	—	—	(3,509)	—	(3,509)	
Accretion of preferred stock dividends	—	—	—	128,643	—	827,041	—	1,782	—	—	(957,466)	—	(957,466)	
Preferred stock dividends paid in cash	—	—	—	(37,207)	—	—	—	—	—	—	—	—	—	
Conversion of preferred stock and cumulative dividends in arrears into common stock	—	—	—	(114,598)	—	(1,271,154)	—	—	9,836,518	983	1,384,769	—	1,385,752	
Conversion of preferred stock dividends in arrears into Convertible notes	—	—	—	—	—	—	—	—	—	—	(737,957)	—	(737,957)	
Conversion of preferred stock dividends in arrears into interest payable	—	—	—	(14,450)	—	(134,083)	—	—	—	—	23,324	—	23,324	
Conversion of preferred stock and cumulative dividends in arrears into note payable	—	—	(520,612)	(390,459)	(236,595)	(1,774,463)	—	—	—	—	—	—	—	
Redemption of preferred stock in cash	—	—	(450,000)	(450,000)	(355,437)	(3,554,370)	—	—	—	—	—	—	—	
Gain on redemption of preferred stock	—	—	—	(130,153)	—	(591,487)	—	—	—	—	721,640	—	721,640	
Issuance of warrants	—	—	—	—	—	—	—	—	—	—	1,835,000	—	1,835,000	
Share-based compensation	—	—	—	—	—	—	—	—	—	—	285,547	—	285,547	
Net income	—	—	—	—	—	—	—	—	—	—	—	4,693,549	4,693,549	
Balance as of December 31, 2009	—	\$	—	\$	—	\$	—	30,557	\$2,630,593	77,713,398	\$ 7,771	\$51,187,754	\$(50,087,293)	\$ 1,108,232
Accretion of preferred stock discount	—	—	—	—	—	—	—	426,889	—	—	(426,889)	—	(426,889)	
Accretion of preferred stock dividends	—	—	—	—	—	—	—	216,870	—	—	(216,870)	—	(216,870)	
Conversion of Series D Preferred Stock to Secured Notes	—	—	—	—	—	—	(30,557)	(3,055,700)	—	—	—	—	—	

Conversion of preferred stock dividends in arrears into Secured notes	—	—	—	—	—	—	—	—	(218,652)	—	—	—	—	—	
Conversion of convertible notes and accrued interest into common stock	—	—	—	—	—	—	—	—	—	442,015	44	55,650	—	55,694	
Issuance of warrants	—	—	—	—	—	—	—	—	—	—	—	307,932	—	307,932	
Share-based compensation	—	—	—	—	—	—	—	—	—	—	—	48,025	—	48,025	
Net loss	—	—	—	—	—	—	—	—	—	—	—	—	(306,789)	(306,789)	
Balance as of December 31, 2010	—	\$	—	\$	—	\$	—	\$	—	78,155,413	\$	7,815	\$50,955,602	\$(50,394,082)	\$ 569,335

The accompanying notes are an integral part of these statements.

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**BIO-key International, Inc. and Subsidiary
STATEMENTS OF CASH FLOWS**

	<u>Years ended December 31,</u>	
	<u>2010</u>	<u>2009</u>
CASH FLOW FROM OPERATING ACTIVITIES:		
Net (Loss) Income	\$ (306,789)	\$ 4,693,549
Less:		
Loss (income) from discontinued operations	(342,983)	(2,872,535)
Gain on disposal of discontinued operations	—	(4,483,902)
Loss from continuing operations	(649,772)	(2,662,888)
Adjustments to reconcile net loss to cash used in operating activities:		
Derivative and warrant fair value adjustments	(1,020,164)	286,492
Depreciation	21,015	29,214
Amortization		
Intangible assets	11,809	21,553
Discounts on convertible debt related to derivatives	659,138	5,336
Allowance for doubtful receivables	—	5,681
Share-based compensation	46,385	222,097
Change in assets and liabilities:		
Accounts receivable trade	496,122	(756,765)
Inventory	5,160	(1,776)
Prepaid expenses and other	(65,005)	(69,068)
Accounts payable	(159,828)	88,028
Accrued liabilities	(77,701)	(268,011)
Deferred revenue	75,287	(467,579)
Net cash used for continuing operations	(657,554)	(3,567,686)
Net cash provided by discontinued operations	344,624	1,912,970
Net cash used for operating activities	(312,930)	(1,654,716)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(9,900)	(42,778)
Deposits	—	(900)
Proceeds from the sale of the business segment	—	7,000,000
Transfer of funds from restricted cash	40,500	—
Net cash provided by continuing operations	30,600	6,956,322
Net cash used for discontinued operations	—	(15,593)
Net cash provided by investing activities	30,600	6,940,729
CASH FLOW FROM FINANCING ACTIVITIES:		
Issuance of short term obligations	—	1,750,000
Proceeds from installment payment of note receivable	500,000	—

Repayment of short term obligations	—	(3,914,922)
Preferred stock dividend paid	—	(37,207)
Redemption of redeemable preferred stock	—	(4,004,370)
Net cash provided by (used for) continuing operations	500,000	(6,206,499)
Net cash used for discontinued operations	—	—
Net cash provided by (used for) financing activities	500,000	(6,206,499)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	217,670	(920,486)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	792,426	1,712,912
CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 1,010,096	\$ 792,426

The accompanying notes are an integral part of these statements.

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BIO-key International, Inc. and Subsidiary
NOTES TO THE FINANCIAL STATEMENTS
December 31, 2010 and 2009

NOTE A —THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

The Company, founded in 1993, develops and markets proprietary fingerprint identification biometric technology and software solutions. We also deliver advanced identification solutions and information services to law enforcement departments, public safety agencies and other government and private sector customers. Our mobile wireless technology provides first responders with critical, reliable, real-time data and images from local, state and national databases.

Basis of Presentation

We have only recently begun to generate significant revenues and have incurred significant losses to date, and at December 31, 2010, we had an accumulated deficit of approximately \$50 million. In addition, broad commercial acceptance of our technology is critical to the Company's success and ability to generate future revenues.

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

The accompanying 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.

Summary of Significant Accounting Policies

A summary of the significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements follows:

1. *Basis of Consolidation*

The accompanying 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. Intercompany accounts and transactions have been eliminated in consolidation.

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2. *Revenue Recognition*

Revenues from software licensing are recognized in accordance with ASC 985-605, "Software Revenue Recognition. Accordingly, revenue from software licensing is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is probable.

The Company intends to enter into arrangements with end users for items which may include software license fees, and services or various combinations thereof. For each arrangement, revenues will be recognized when evidence of an agreement has been documented, the fees are fixed or determinable, collection of fees is probable, delivery of the product has occurred and no other significant obligations remain.

Multiple-Element Arrangements: For multiple-element arrangements, the Company applies the residual method in accordance with ASC 985-605. The residual method requires that the portion of the total arrangement fee attributable to the undelivered elements be deferred based on its VSOE of fair value and subsequently recognized as the service is delivered. The difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements, which is generally the software license. VSOE of fair value for all elements in an arrangement is based upon the normal pricing for those products and services when sold separately. VSOE of fair value for support services is additionally determined by the renewal rate in customer contracts. The Company has established VSOE of fair value for support as well as consulting services.

License Revenues: Amounts allocated to license revenues are recognized at the time of delivery of the software and all other revenue recognition criteria discussed above have been met.

Revenue from licensing software, which requires significant customization and modification, is recognized using the percentage of completion method, based on the hours of effort incurred by the Company in relation to the total estimated hours to complete. In instances where third party hardware, software or services form a significant portion of a customer's contract, the Company recognizes revenue for the element of software customization by the percentage of completion method described above. Otherwise, third party hardware, software, and services are recognized upon shipment or acceptance as appropriate. If the Company makes different judgments or utilizes different estimates of the total amount of work expected to be required to customize or modify the software, the timing and revenue recognition, from period to period, and the margins on the project in the reporting period, may differ materially from amounts reported. Anticipated contract losses are recognized as soon as they become known and are estimable.

Service Revenues: Revenues from services are comprised of maintenance and consulting and implementation services. Maintenance revenues include providing for unspecified when-and-if available product updates and customer telephone support services, and are recognized ratably over the term of the service period. Consulting services are generally sold on a time-and-materials basis and include a range of services including installation of software and assisting in the design of interfaces to allow the software to operate in customized environments. Services are generally separable from other elements under the arrangement since performance of the services are not essential to the functionality of any other element of the transaction and are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services. Revenues from services are generally recognized as the services are performed.

The Company provides customers, free of charge or at a minimal cost, testing kits which potential licensing customers may use to test compatibility/acceptance of the Company's technology with the customer's intended applications.

Costs and other expenses: Includes professional compensation and other direct contract expenses, as well as costs attributable to the support of client service professional staff, depreciation and amortization costs related to assets used in revenue-generating activities, and other costs attributable to serving the Company's client base. Professional compensation consists of payroll costs and related benefits including stock-based compensation and bonuses. Other direct contract expenses include costs directly attributable to client engagements, such as out-of-pocket costs including travel and subsistence for client service professional staff, costs of hardware and software and costs of subcontractors. The allocation of lease and facilities charges for occupied offices are included in costs of service.

The Company accounts for its warranties under the FASB ASC 450 "Contingencies." The Company generally warrants that its products are free from defects in material and workmanship for a period of one year from the date of initial acceptance by our customers. The warranty does not cover any losses or damage that occurs as a result of improper installation, misuse or neglect or repair or modification by anyone other than the Company or its authorized repair agent. The

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Company's policy is to accrue anticipated warranty costs based upon historical percentages of items returned for repair within one year of the initial sale. The Company's repair rate of products under warranty has been minimal, and a historical percentage has not been established. The Company's software license agreements generally include certain provisions for indemnifying customers against liabilities if the Company's software products infringe upon a third party's intellectual property rights. The Company has not provided for any reserves for warranty liabilities as it was determined to be immaterial.

3. Cash and Cash Equivalents

Cash equivalents consist of certificates of deposit and all other liquid investments with original maturities of three months or less.

4. Accounts Receivable

Accounts receivable billed and unbilled are carried at original amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful receivables by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. Accounts receivable are written off when deemed uncollectible. Recoveries of accounts receivable previously written off are recorded when received.

5. Accounting for Acquisitions

Acquisitions are accounted for under the purchase method of accounting, which resulted in recording significant goodwill and other intangible asset balances. The purchase prices are allocated to assets acquired and liabilities assumed at their estimated fair values on the date of the acquisitions, as determined by management, and by appraisals with respect to identifiable intangible assets. Accounting for acquisitions involves significant judgments and estimates regarding fair values of acquired intangible assets, which are based on projections of future revenues and cash flows, assumptions regarding discount factors, royalty rates, tax rates, amortization methodologies and related useful lives. Developed technology (software), copyrighted software, marketing agreements, customer relationships and trademarks are valued using the income approach.

6. Property and Equipment, Intangible Assets and Depreciation and Amortization

Property and equipment are stated at cost. Depreciation is provided for in amounts sufficient to relate the cost of depreciable assets to operations over the estimated service lives, principally using straight-line methods. Leasehold improvements are amortized over the shorter of the life of the improvement or the lease term, using the straight-line method.

The estimated useful lives used to compute depreciation and amortization for financial reporting purposes are as follows:

<i>Equipment and leasehold improvements</i>	
Equipment	3-5 years
Furniture and fixtures	3-5 years
Software	3 years
Leasehold improvements	life or lease term

Intangible assets consist of patents. Patent costs are capitalized until patents are awarded. Upon award, such costs are amortized using the straight-line method over their respective economic lives. If a patent is denied, all costs are charged to operations in that year.

Deferred financing fees related to the issuance of long-term obligations are capitalized and amortized to interest expense over the lives of the related debt using the effective interest rate method.

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7. Derivative and Warrant Financial Instruments

In connection with the sale of debt or equity instruments, we may sell options or warrants to purchase our common stock. In certain circumstances, these options or warrants may be classified as derivative liabilities, rather than as equity. Additionally, the debt or equity instruments may contain embedded derivative instruments, such as conversion options, which in certain circumstances may be required to be bifurcated from the associated host instrument and accounted for separately as a derivative instrument asset or liability.

Our derivative instrument liability is re-valued at the end of each reporting period, with changes in the fair value of the derivative liability recorded as charges or credits to income, in the period in which the changes occur. For options, warrants and bifurcated conversion options that are accounted for as derivative instrument liabilities, we determine the fair value of these instruments using the Black-Scholes or Binomial option pricing model. That model requires assumptions related to the remaining term of the instruments and risk-free rates of return, our current common stock price and expected dividend yield, and the expected volatility of our common stock price over the life of the option. The identification of, and accounting for, derivative instruments and the assumptions used to value them can significantly affect our financial statements.

8. Impairment or Disposal of Long Lived Assets, including Intangible Assets

We review our long-lived assets, including intangible assets subject to amortization, whenever events or changes in circumstances indicate that the carrying amount of such an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to the future undiscounted cash flows the assets are expected to generate. If such assets are considered impaired, the impairment to be recognized is equal to the amount by which the carrying value of the assets exceeds their fair value determined by either a quoted market price, if any, or a value determined by utilizing a discounted cash flow technique. In assessing recoverability, we must make assumptions regarding estimated future cash flows and discount factors. If these estimates or related assumptions change in the future, we may be required to record impairment charges. Intangible assets with determinable lives are amortized over their estimated useful lives, based upon the pattern in which the expected benefits will be realized, or on a straight-line basis, whichever is greater. We did not record any impairment charges in any of the years presented.

9. Advertising Expense

The Company expenses the costs of advertising as incurred. Advertising expenses for the years ended December 31, 2010 and 2009, were approximately \$277,000 and \$72,000, respectively.

10. *Deferred Revenue*

Deferred revenue includes customer advances and amounts that have been billed per the contractual terms but have not been recognized as revenue. The majority of these amounts are related to maintenance contracts for which the revenue is recognized ratably over the applicable term, which generally is 12 months from the date the customer accepts the products.

11. *Research and Development Expenditures*

Research and development expenses include costs directly attributable to the conduct of research and development programs primarily related to the development of our software products and improving the efficiency and capabilities of our existing software. Such costs include salaries, payroll taxes, employee benefit costs, materials, supplies, depreciation on research equipment, services provided by outside contractors, and the allocable portions of facility costs, such as rent, utilities, insurance, repairs and maintenance, depreciation and general support services. All costs associated with research and development are expensed as incurred.

12. *Earnings Per Share of Common Stock*

Earnings per share of common stock-basic is computed by dividing net income applicable to common stockholders by the weighted-average number of common shares outstanding for the period. Earnings per share of common stock-assuming dilution reflects the maximum potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock and would then share in the net income of the Company. See Note U - Earnings

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Per Share "EPS", for additional information.

13. *Accounting for Stock-Based Compensation*

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

The compensation expense recognized under ASC 718 increased the Company's loss from continuing operations by \$46,385 and \$222,097 with no effect per share (basic and diluted), for the years ended December 31, 2010 and 2009 respectively.

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

	Year ended December 31,	
	2010	2009
Selling, general and administrative	13,907	198,201
Research, development and engineering	32,478	23,896
	<u>\$ 46,385</u>	<u>\$ 222,097</u>

Valuation Assumptions for Stock Options

For the years ended December 31, 2010 and 2009, 510,000 and 3,019,258 stock options were granted, respectively. The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Year ended
December 31,

	2010	2009
Risk free interest rate	2.10-2.22%	0.61-3.00%
Expected life of options (in years)	4.30	1.42-6.34
Expected dividends	0%	0%
Volatility of stock price	115%	87-123%

The stock volatility for each grant is determined based on the review of the experience of the weighted average of historical daily price changes of the Company's common stock over the expected option term. The expected term was determined using the simplified method for estimating expected option life, which qualify as "plain-vanilla" options; and the

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risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

14. *Income Taxes*

The provision for, or benefit from, income taxes includes deferred taxes resulting from the temporary differences in income for financial and tax purposes using the liability method. Such temporary differences result primarily from the differences in the carrying value of assets and liabilities. Future realization of deferred income tax assets requires sufficient taxable income within the carryback, carryforward period available under tax law. The Company evaluates, on a quarterly basis whether, based on all available evidence, if it is probable that the deferred income tax assets are realizable. Valuation allowances are established when it is more likely than not that the tax benefit of the deferred tax asset will not be realized. The evaluation, as prescribed by ASC 740-10, "Income Taxes," includes the consideration of all available evidence, both positive and negative, regarding historical operating results including recent years with reported losses, the estimated timing of future reversals of existing taxable temporary differences, estimated future taxable income exclusive of reversing temporary differences and carryforwards, and potential tax planning strategies which may be employed to prevent an operating loss or tax credit carryforward from expiring unused. Because of the Company's historical performance and estimated future taxable income, a full valuation allowance has been established.

The Company accounts for uncertain tax provisions in accordance with ASC 740-10-05 "Accounting for Uncertainty in Income Taxes." The ASC clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. The ASC prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The ASC provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

15. *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenues and expenses during the reporting period, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Estimates and assumptions which, in the opinion of management are used in accounting for, among other things, long-term contracts, allowances for uncollectible receivables, recoverability of long-lived assets, depreciation and amortization, valuation of deferred income taxes, secured notes and related discounts, embedded derivatives, preferred stock, share-based compensation, and warrants outstanding.

16. *Comprehensive Income/(Loss)*

Comprehensive income (loss) consists of net loss and other gains and losses affecting shareholders' equity that, under generally accepted accounting principles, are excluded from net income (loss) in accordance with ASC 220. The Company, however, does not have any components of other comprehensive income (loss) as defined by ASC 220 and therefore, for the years ended December 31, 2010 and 2009, comprehensive income (loss) is equivalent to the Company's reported net income (loss). Accordingly, a separate statement of comprehensive income (loss) is not presented.

17. *Recent Accounting Pronouncements*

In July 2010, the FASB issued Accounting Standards Update 2010-20, "Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The adoption of ASU 2010-20 did not have a significant impact on its consolidated financial statements

In April 2010, the FASB issued ASU 2010-17 (ASU 2010-17), "Revenue Recognition-Milestone Method (Topic 605): Milestone Method of Revenue Recognition." The amendments in this Update are effective on a prospective basis for

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milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. Early adoption is permitted. If a vendor elects early adoption and the period of adoption is not the beginning of the entity's fiscal year, the entity should apply the amendments retrospectively from the beginning of the year of adoption. The Company will adopt this standard effective January 1, 2011. The Company does not expect the provisions of ASU 2010-17 to have a material effect on the financial position, results of operations or cash flows of the Company.

In September 2009, the FASB issued ASU 2009-13, *Multiple Element Arrangements*. ASU 2009-13 addresses the determination of when the individual deliverables included in a multiple arrangement may be treated as separate units of accounting. ASU 2009-13 also modifies the manner in which the transaction consideration is allocated across separately identified deliverables and establishes definitions for determining fair value of elements in an arrangement. This standard must be adopted by the Company no later than January 1, 2011 with earlier adoption permitted. The Company will adopt this standard effective January 1, 2011. The Company is currently evaluating the impact, if any, that this standard update will have on its consolidated financial statements.

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.

NOTE B—DISCONTINUED OPERATIONS

Law Enforcement Division

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

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

As consideration for the Asset Sale, Buyer paid the Company an aggregate purchase price of approximately \$11.3 million. Of that amount, approximately \$7.0 million was paid in cash at the closing of the Asset Sale, and approximately \$300,000 was paid pursuant to the working capital adjustment provided for in the Purchase Agreement. Buyer also issued a promissory note (the "Note") in the original principal amount of \$4.0 million in favor of the Company. The Note is guaranteed by SilkRoad Equity, LLC ("SilkRoad"), a private investment firm and a principal owner of Buyer, and is secured by all of the intellectual property assets of the Business transferred to Buyer as part of the Asset Sale. In addition, at the closing of the Asset Sale, the Company issued to SilkRoad a warrant to purchase up to 8 million shares of the Company's common stock at an exercise price of \$0.30 per share. This warrant was to expire if not exercised prior to the fifth anniversary of the closing (see Note E).

Prior to the sale, the Business had been reported as a separate segment. The Business has been reported as a discontinued operation and all periods presented have been recast accordingly to reflect these operations as discontinued.

Revenues and net income for the Law Enforcement division Segment for the years ended December 31, 2010 and 2009 were as follows:

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	Year Ended December 31,	
	2010	2009
Revenues	\$ 492,672	\$ 8,561,979
Net income	342,983	2,872,535

During the year ended December 31, 2010, the Company recorded income from a contract delivered under our arrangement with Buyer which was reduced by cost of sales and expenses for professional fees. The Company does not expect any additional income from discontinued operations in the future. The Company and Buyer concluded the post-closing purchase price adjustments on August 3, 2010, which resulted in Buyer paying an additional \$76,313 to the Company, and whereby Buyer returned approximately \$263,000 of accounts receivable in lieu of a cash payment for the same amount, of which approximately \$173,000 has been collected, \$64,000 has been determined uncollectable and expensed to discontinued operations and \$26,000 remained uncollected as at December 31, 2010.

NOTE C—FAIR VALUES OF FINANCIAL INSTRUMENTS

Cash and cash equivalents, accounts and notes receivable, accounts payable, accrued liabilities, and notes payable, are carried at, or approximate, fair value because of their short-term nature. The Company issued warrants to purchase shares of the Company's Common stock as part of various debt financings. The Company recorded the warrants at their relative fair value as of the inception date of the agreement. As the warrants were classified as equity instruments, no further accounting adjustment is required. The Company utilizes both the Binomial Option Pricing Model and the Black Scholes Option Pricing Model (see "Note L — Notes Payable").

NOTE D—CONCENTRATION OF RISK

Financial instruments which potentially subject the Company to risk primarily consist of cash and receivables.

The Company maintains its cash balances in a financial institution in Nevada. These balances are insured by the Federal Deposit Insurance Corporation up to \$250,000. The Company has not incurred any losses on these accounts.

The Company extends credit to customers on an unsecured basis in the normal course of business. The Company's policy is to perform an analysis of the recoverability of its receivables at the end of each reporting period and to establish allowances where appropriate. The Company analyzes historical bad debts and contract losses, customer concentrations, and customer credit-worthiness when evaluating the adequacy of the allowances.

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

	Years Ended December 31,	
	2010	2009
Customer A	—	28%
Customer C	18%	24%
Customer D	16%	—
Customer E	14%	—
Customer F	12%	—

* Less than 10% of total revenue

The Company had concentrations of customers in certain industry groups which represented 10% or more of the Company's total revenue, as follows:

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	Years Ended December 31,	
	2010	2009
Government	0%	0%
Commercial	100%	100%

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

	As of December 31,	
	2010	2009
Customer A	—	59%
Customer B	—	16%
Customer G	18%	—
Customer H	12%	—

* Less than 10% of total accounts receivable

NOTE E—NOTE RECEIVABLE

Note Receivable consisted of the following as of December 31:

	2010	2009
Note Receivable — Current	\$ 2,167,000	\$ 1,334,000
Note Receivable — Non-Current	1,333,000	2,666,000

As consideration for the Asset Sale (see “Note B — Discontinued Operations”), Buyer paid the Company an aggregate purchase price of approximately \$11.3 million. Of that amount, approximately \$7.0 million was paid in cash at the closing of the Asset Sale, and approximately \$300,000 was paid pursuant to the working capital adjustment provided for in the Purchase Agreement. Buyer also issued a promissory note (the “Note”) in the original principal amount of \$4 million in favor of the Company. The Note bears interest, payable on a quarterly basis, at a rate per annum equal to six percent (6%) compounded annually on the principal sum from time to time outstanding. The Note is guaranteed by SilkRoad, a private investment firm and a principal owner of Buyer, and is secured by all of the intellectual property assets that were sold to Buyer.

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. The Amendment and Waiver did not change the timing or amount of the remaining annual payments described in the Note; \$1,333,000 is due to be paid to the Company in December 2011 and also in December 2012.

In exchange for this deferral, the Buyer made a cash principal payment of \$500,000, 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.

Accrued interest receivable was \$59,108 and \$15,333 as of December 31, 2010 and 2009, respectively, and is included in prepaid expenses and other.

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NOTE F—PREPAID EXPENSES AND OTHER

Prepaid expenses and other consisted of the following as of December 31:

	2010	2009
Prepaid insurance, software licenses and other	\$ 62,931	\$ 62,330
Income taxes receivable	31,224	—
Interest receivable	59,108	15,333
Other	35,653	46,248
Total	<u>\$ 188,916</u>	<u>\$ 123,911</u>

NOTE G—EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consisted of the following as of December 31:

	2010	2009
Equipment	\$ 245,849	\$ 235,948
Furniture and fixtures	99,199	99,199
Software	28,624	28,624
Leasehold improvements	39,975	39,975
	<u>413,646</u>	<u>403,746</u>
Less accumulated depreciation and amortization	<u>(385,518)</u>	<u>(364,503)</u>
Total	<u>\$ 28,128</u>	<u>\$ 39,243</u>

Depreciation and amortization were \$21,015 and \$29,214 for the periods ending December 31, 2010 and 2009, respectively.

NOTE H—OTHER ASSETS

Intangible Assets

Intangible assets consisted of the following as of December 31:

	2010			2009		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount

Patents and patents pending	\$ 287,248	\$ (68,798)	\$ 218,450	\$ 287,248	\$ (56,989)	\$ 230,259
Total	\$ 287,248	\$ (68,798)	\$ 218,450	\$ 287,248	\$ (56,989)	\$ 230,259

Aggregate amortization expense for the years ended December 31, 2010 and 2009, was \$11,809 and \$11,876, respectively. The estimated aggregate amortization expense of intangible assets for the years following December 31, 2010 is approximately \$11,500 for 2011 through 2015 and \$160,950 thereafter.

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Restricted cash

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

NOTE I—ACCRUED LIABILITIES

Accrued liabilities consisted of the following as of December 31:

	<u>2010</u>	<u>2009</u>
Installment payment to The Shaar Fund, Ltd. (see Note L)	\$ 500,000	\$ —
Compensation	39,864	92,860
Compensated absences	154,419	143,387
Dividends payable (see Note L)	128,644	128,644
Income tax payable	—	188,000
Accrued legal and accounting fees	130,000	90,000
Other	126,190	65,874
Total	\$ 1,079,117	\$ 708,765

NOTE J—RELATED PARTY

Consulting Arrangement with Thomas J. Colatosti ("Colatosti")

In connection with his appointment to the Board of Directors in September 2002, and as acting Chief Financial Officer from November 2008 to December 2009, the Company has entered into a number of consulting arrangements with Colatosti. Under the most recent arrangement, which was entered into on January 12, 2010, Mr. Colatosti provides services to the Company and its subsidiary for a two-year term ending December 31, 2011 at a rate of \$5,000 per month.

Mr. Colatosti has substantial experience in the biometric industry and in addition to his role as the Chairman of the Board of Directors of the Company, provides extensive service to the Company in the areas of strategic planning and corporate finance. For the years ended December 31, 2010 and 2009, the Company paid Mr. Colatosti approximately \$60,000 and \$150,000, respectively.

In December 2009 the Company issued Colatosti a 7% convertible Promissory Note with a principal balance of \$64,878. In December 2010, Mr. Colatosti exchanged shares of Series D Convertible Preferred Stock and the convertible Promissory Note for a new non-convertible 7% Secured Promissory Note with a principal amount of \$350,804 (see "Note L - Notes Payable").

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NOTE K—DEFERRED REVENUE

The components of Deferred Revenue are as follows as of December 31:

	<u>2010</u>	<u>2009</u>
Current Portion		
Maintenance contracts	\$ 242,342	\$ 177,880

Fully deferred systems, installation and acceptance revenue	39,051	23,116
	<u>281,393</u>	<u>200,996</u>
Long-Term Portion		
Maintenance contracts	4,281	9,391
	<u>4,281</u>	<u>9,391</u>
Total	<u>\$ 285,674</u>	<u>\$ 210,387</u>

Maintenance contracts include provisions for unspecified when-and-if available product updates and customer telephone support services, and are recognized ratably over the term of the service period. Fully deferred systems, installation and acceptance revenue relates to projects that have been billed per the contractual terms, however because of undelivered elements or acceptance criteria, revenue has not yet been recognized. These amounts are expected to be completed within the next 12 months and are classified as current liabilities.

Long-term maintenance contracts are comprised of multiple year support contracts, and are recognized ratably over the applicable term.

NOTE L—NOTES PAYABLE

The 2009 Exchange Agreement

Effective as of November 12, 2009, the Company entered into a Securities Exchange Agreement (the “2009 Exchange Agreement”) with The Shaar Fund, Ltd. (“Shaar”) and Colatosti, with respect to its Series A Convertible Preferred Stock (the “Series A Preferred Stock”). Pursuant to the 2009 Exchange Agreement, the Company and the holders of the outstanding shares of the Series A Preferred Stock, such holders being Shaar (27,932 shares) and Colatosti (2,625 shares), agreed to the following:

(a) the holders would exchange their shares of Series A Preferred Stock for an equal number of shares of the Company’s Series D Convertible Preferred Stock (the “Series D Preferred Stock”) and

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

On July 27, 2010, one of the Noteholders converted \$27,615 of interest and \$28,079 of principal into 442,015 shares of common stock, reducing the principal balance to \$709,878. In December 2010, the remainder of the principal and accrued and unpaid interest on the Convertible Notes were exchanged for Secured Promissory Notes as detailed below.

The 2010 Exchange Agreement

Effective as of December 31, 2010, the Company entered into a Securities Exchange Agreement (the “2010 Exchange Agreement”) with Shaar and 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 and has been included in accrued liabilities at December 31, 2010. 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,

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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”).

The Shaar Note is scheduled to be repaid by the Company in cash in five principal installments, as follows: (i) \$300,000 on April 30, 2011, (ii) \$300,000 on July 31, 2011, (iii) \$300,000 on October 31, 2011, (iv) \$1,400,000 on December 31, 2011 and (v) \$857,759 on December 31, 2012. Interest on the Shaar note accrues at the rate of seven percent per annum and is payable with each principal installment.

Pursuant to the Exchange Agreement, the Company will make a cash payment to Shaar in the amount of \$500,000 at the closing of the exchange and also agreed to pay 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. As at December 31, 2010, the \$500,000 installment and the dividends payable of \$125,209 were included in the balance of accrued liabilities (see “Note I — Accrued Liabilities”).

The principal and interest, which will also accrue at a rate of seven percent per annum under the Colatosti Note is scheduled to be repaid by the Company in cash on December 31, 2012. The Company’s obligations under the Shaar Note and the Colatosti Note are secured by

substantially all of the Company's assets and Mr. Colatosti's right of payment under the Colatosti Note is subordinated to the rights of Shaar under the Shaar Note.

The Company recorded the warrants at their relative fair value as of the inception date of the agreement. As the warrants were classified as equity instruments, no further accounting adjustment is required. The initial fair value of the warrants was recorded as a discount to the Secured Promissory Notes and will be amortized to interest expense over the two-year expected term of the debt, using the effective interest method.

Note financing and warrants consisted of the following as of December 31:

	<u>2010</u>	<u>2009</u>
Current Portion		
2005		
FMV of warrants	\$ —	\$ 47,773
2009		
Convertible promissory notes	—	737,957
Discount	—	(659,138)
FMV of embedded derivatives	—	344,891
2010		
Secured promissory notes	2,300,000	—
Discount	(201,861)	—
Total	\$ 2,098,139	\$ 471,483
Long-Term Portion		
2006		
FMV of warrants	—	63,901
2010		
Secured promissory notes	1,208,563	—
Discount	(106,071)	—
Total	\$ 1,102,492	\$ 63,901

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Discount on Secured Promissory Notes

The fair value of the warrants, which was represented by the incremental value of the 8,000,000 warrants issued to Shaar over the value of the 5,108,333 warrants exchanged by Shaar, as detailed above, was recorded as a discount to the Secured Promissory Notes. The 8,000,000 warrants were valued using the Black Scholes model with the following assumptions:

	Year ended December 31,	
	<u>2010</u>	<u>2009</u>
Dividend Yield	0%	n/a
Annual volatility	112%	n/a
Risk-free interest rate	2.01%	n/a

NOTE M—SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of Biometric products.

Prior to the sale of the Law Enforcement division in December 2009, Law had been reported as a separate segment.

Geographically, North American sales accounted for approximately 95% and 96% of the Company's total sales for fiscal years 2010 and 2009, respectively.

NOTE N—COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company does not own any real estate but conducts operations from three leased premises. These non-cancelable operating leases expire at various dates through 2014. In addition to base rent, the Company pays for property taxes, maintenance, insurance and other occupancy expenses according to the terms of the individual leases.

Future minimum rental commitments of non-cancelable operating leases are approximately as follows:

2011	\$	135,726
2012		136,280
2013		137,370
2014		92,097
	\$	<u>501,473</u>

Rental expense was approximately \$163,000 and \$138,000 during 2010 and 2009, respectively.

Employment Agreements

The Company has employment agreements with two of its officers. These agreements allow the continuation of the employee's salary in the event of termination without cause. The agreements also acknowledge the employee's eligibility to participate in the Company's bonus and option plans, the terms of which have not yet been established. As of December 31, 2010, the aggregate commitment under these agreements was approximately \$384,000.

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Legal Proceedings

In the normal course of business, the Company periodically becomes involved in litigation. As of December 31, 2010, in the opinion of management, the Company had no pending litigation that would have a material adverse effect on the Company's financial position, results of operations or cash flows.

NOTE O— EQUITY

1. Mezzanine Equity

Redeemable Preferred Stock

Within the limits and restrictions provided in the Company's Certificate of Incorporation, the Board of Directors has the authority, without further action by the shareholders, to issue up to 5,000,000 shares of preferred stock, \$.0001 par value per share, in one or more series, and to fix, as to any such series, any dividend rate, redemption price, preference on liquidation or dissolution, sinking fund terms, conversion rights, voting rights, and any other preference or special rights and qualifications.

Series D Convertible Preferred Stock

The Company issued 30,557 shares of its redeemable Series D Convertible Preferred Stock to Shaar and Colatosti on December 28, 2009, in exchange for 30,557 shares of Series A Convertible Preferred Stock held by those shareholders. Pursuant to the 2010 Exchange Agreement (see "Note L — Notes Payable"), Shaar and Mr. Colatosti exchanged all of their outstanding shares of the Company's Series D Convertible Preferred Stock, including all accrued and unpaid dividends thereon, for new non-convertible 7% Secured Promissory Notes.

2. Permanent Equity

Common Stock

The Company is authorized to issue 170,000,000 shares of common stock, \$.0001 par value per share, of which 78,155,413 were outstanding as of December 31, 2010.

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

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

During the year ended December 31, 2010, one of the Convertible Noteholders converted \$27,615 of interest and \$28,079 of principal into 442,015 shares of common stock. During the year ended December 31, 2009, preferred stockholders converted accumulated dividends of \$1,385,752 into 9,836,518 shares of the Company's common stock.

3. Warrants

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

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	<u>Total Warrants</u>	<u>Weighted average exercise price</u>	<u>Weighted average remaining life (in years)</u>	<u>Aggregate intrinsic value</u>
Outstanding, as of December 31, 2008	10,566,375	\$ 0.95		
Granted	13,000,000	0.30		
Exercised	—	—		
Expired	(6,790,584)	1.23		
Outstanding, as of December 31, 2009	16,775,791	\$ 0.33	4.09	
Granted	8,000,000	0.30		
Exercised	—	—		
Forfeited	(13,108,333)	0.30		
Expired	(1,405,843)	0.52		
Outstanding, as of December 31, 2010	10,261,615	\$ 0.32	4.10	—
Vested or expected to vest at December 31, 2010	10,261,615	\$ 0.32	4.10	—
Exercisable at December 31, 2010	10,261,615	\$ 0.32	4.10	—

The warrants outstanding and exercisable at December 31, 2010 were in the following exercise price ranges:

<u>Range of exercise prices</u>	<u>Warrants outstanding and Exercisable</u>	
	<u>Number of warrants</u>	<u>Weighted average remaining life (in years)</u>
\$ 0.30	9,861,615	4.24
0.75	400,000	0.61
	<u>10,261,615</u>	

NOTE P—STOCK-BASED COMPENSATION*1996 Stock Option Plan*

During 1996, the Board of Directors and stockholders of the Company adopted the 1996 Stock Option Plan (the 1996 Plan). Under the 1996 Plan, 750,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 100% of fair market value for incentive stock options and 50% for all others. The term of stock options granted may not exceed ten years. Options issued under the Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The Plan expired in May 2005.

1999 Stock Option Plan

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

[Table of Contents](#)*2004 Stock Option Plan*

On October 12, 2004, the Board of Directors of the Company approved the 2004 Stock Option Plan (the 2004 Plan). The 2004 Plan has not yet been presented to stockholders for approval and thus incentive stock options are not available under this plan. Under the terms of this plan, 4,000,000 shares of common stock are reserved for issuance to employees, officers, directors, and consultants of the Company at exercise prices which may not be below 85% of fair market value. The term of stock options granted may not exceed ten years. Options issued under the Plan vest pursuant to the terms of stock option agreements with the recipients. In the event of a change in control, as defined, all options outstanding vest immediately. The Plan expires in October 2014.

Non-Plan Stock Options

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

Stock Option Activity

Information summarizing option activity is as follows:

	Number of Options					Weighted average exercise price	Weighted average remaining life (in years)	Aggregate intrinsic value
	1996 Plan	1999 Plan	2004 Plan	Non Plan	Total			
Outstanding, as of December 31, 2008	80,000	335,000	2,837,941	3,755,000	7,007,941	\$ 0.78		
Granted	—	500,000	1,189,417	1,329,841	3,019,258	0.24		
Exercised	—	—	—	—	—	—		
Forfeited	(35,000)	(135,000)	(1,510,677)	(3,455,000)	(5,135,677)	0.89		
Expired	—	(200,000)	(443,492)	(300,000)	(943,492)	0.73		
Outstanding, as of December 31, 2009	45,000	500,000	2,073,189	1,329,841	3,948,030	\$ 0.24		
Granted	—	—	510,000	—	510,000	0.40		
Exercised	—	—	—	—	—	—		
Forfeited	—	—	—	—	—	—		
Expired	(45,000)	—	(2,500)	—	(47,500)	0.48		
Outstanding, as of December 31, 2010	—	500,000	2,580,689	1,329,841	4,410,530	0.25	3.76	\$ 58,038
Vested or expected to vest at December 31, 2010					4,296,351	0.25	3.67	\$ 57,515
Exercisable at December 31, 2010					3,759,862	0.24	3.32	\$ 50,706

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The options outstanding and exercisable at December 31, 2010 were in the following exercise price ranges:

Range of exercise prices	Options Outstanding			Options Exercisable		
	Number of shares	Weighted average exercise price	Weighted average remaining life (in years)	Number exercisable	Weighted average exercise price	Weighted average remaining life (in years)
\$ 0.07-0.21	1,696,272	\$ 0.12	4.92	1,455,604	\$ 0.11	0.11
0.22-0.40	2,299,258	0.30	2.67	2,229,258	0.30	0.30
0.41-0.68	340,000	0.46	6.02	—	—	—
0.69-0.94	75,000	0.94	0.84	75,000	0.94	0.94
\$ 0.07-0.94	4,410,530			3,759,862		

The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.14 as of December 31, 2010, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of December 31, 2010 was 1,193,604.

The weighted average fair value of options granted during the years ended December 31, 2010 and 2009 was \$0.19 and \$0.10 per share, respectively. The total intrinsic value of options exercised during the years ended December 31, 2010 and 2009 was \$0. The total fair value of shares vested during the years ended December 31, 2010 and 2009 was \$48,026 and \$327,382 respectively.

As of December 31, 2010 future compensation cost related to nonvested stock options is \$60,683 and will be recognized over an estimated weighted average period of 1.16 years.

NOTE Q— GAIN ON REDEMPTION OR EXCHANGE OF REDEEMABLE PREFERRED STOCK

Pursuant to the Settlement Agreement entered into between the Company and the Longview Entities in July 2009, the Company paid a total cash settlement amount of \$2,164,922 to the Longview Entities for the redemption of the outstanding shares of the Company's Series B and C Convertible Preferred Stock held by the Longview Entities, and accumulated and unpaid dividends therein. The settlement amount represented a

discount to the value of the Shares and accumulated and unpaid dividends, resulting in a gain to the Company of \$721,640. The Company increased Additional Paid in Capital by the amount of this gain.

There was no gain or loss on the exchange of the Company's Series D Convertible Preferred Stock and Convertible Notes to Secured Promissory Notes, pursuant to the 2010 Exchange Agreement (see "Note L — Notes Payable" and "Note O — Equity").

NOTE R—INCOME TAXES

The Company has deferred taxes due to income tax credits, net operating loss carryforwards, and the effect of temporary differences between the carrying values of certain assets and liabilities for financial reporting and income tax purposes. Significant components of deferred taxes are as follows at December 31:

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	<u>2010</u>	<u>2009</u>
Current asset:		
Accrued compensation	\$ 76,000	\$ 79,000
Accounts receivable allowance	5,000	5,000
Non-current asset (liability):		
Basis differences in fixed assets	30,000	29,000
Basis differences in intangible assets	27,000	22,000
Income tax credits	1,719,000	1,939,000
Net operating loss carryforwards	12,833,000	12,643,000
Installment sale	(846,000)	(967,000)
Valuation allowances	(13,844,000)	(13,750,000)
	<u>\$ —</u>	<u>\$ —</u>

The Company has a valuation allowance against the full amount of its net deferred taxes due to the uncertainty of realization of the deferred tax assets due to operating loss history of the Company. The Company currently provides a valuation allowance against deferred taxes when it is more likely than not that some portion, or all of its deferred tax assets will not be realized. The valuation allowance could be reduced or eliminated based on future earnings and future estimates of taxable income. Similarly, income tax benefits related to stock options exercised have not been recognized in the financial statements.

The Company reduced its deferred tax assets and the associated valuation allowance for gross unrecognized tax affected benefits by approximately \$3,450,000. There was no adjustment to accumulated deficit as a result of these unrecognized tax benefits since there was a full valuation allowance against the related deferred tax assets. If these unrecognized tax benefits are ultimately recognized, they would have no impact on the effective tax rate due to the existence of the valuation allowance.

As of December 31, 2010, the Company has federal and state net operating loss carryforwards of approximately 45,809,000 and 15,600,000, respectively, subject to expiration between 2011 and 2030. These net operating loss carryforwards are subject to the limitations under Section 382 of the Internal Revenue Code due to changes in the equity ownership of the Company.

A reconciliation of the effective income tax rate on operations reflected in the Statements of Operations to the US Federal statutory income tax rate is presented below.

	<u>2010</u>	<u>2009</u>
US Federal statutory income tax rate	34%	34%
State taxes, net	0	0
Permanent differences	34	24
Effect of net operating loss	(68)	(58)
Effective tax rate	<u>0%</u>	<u>0%</u>

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The Company has not been audited by the Internal Revenue Service ("IRS") or any states in connection with income taxes. The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The periods from 2007-2010 remain open to examination by the IRS and state jurisdictions. The Company believes it is not subject to any tax audit risk beyond those periods. The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. The Company does not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any significant interest expense recognized during the

NOTE S—SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

	Years ended December 31,	
	2010	2009
Cash paid for:		
Interest	\$ —	\$ 78,681
Noncash Financing Activities:		
Issuance of secured debt in exchange for Series D redeemable preferred stock	3,055,700	—
Issuance of secured debt in exchange for cumulative dividends on Series D redeemable preferred stock	218,652	—
Issuance of secured debt in exchange for convertible debt	709,878	—
Issuance of secured debt in exchange for accumulated interest on convertible debt	24,333	—
Issuance of convertible debt in exchange of discounted Series B redeemable preferred stock	—	390,459
Gain on redemption of Series B redeemable preferred stock	—	130,153
Issuance of convertible debt in exchange of discounted Series C redeemable preferred stock	—	1,774,463
Gain on redemption of Series C redeemable preferred stock	—	591,487
Issuance of Series D redeemable preferred stock in exchange for Series A preferred stock	—	3,055,700
Issuance of convertible debt in exchange for cumulative dividends on Series A preferred Stock	—	737,957
Issuance of common stock in exchange for Series A, Series B, and Series C preferred stock and cumulative dividends in arrears, thereon	—	1,385,752
Issuance of common stock in exchange for principal and interest on convertible promissory note	55,694	—
Origination of warrants in conjunction with convertible debt financing	—	373,956
Origination of warrants in conjunction with sale of law enforcement division	—	1,461,044
Origination of warrants in conjunction with secured debt financing	307,932	—
Origination of embedded derivatives with Series D redeemable preferred stock	—	430,398
Origination of note receivable in exchange for proceeds on the sale of the law enforcement division	—	4,000,000

NOTE T—PROFIT SHARING PLAN

The Company has established a savings plan under section 401(k) of the Internal Revenue Code. All employees of the Company, after completing one day of service are eligible to enroll in the 401(k) plan. Participating employees may elect to defer a portion of their salary on a pre-tax basis up to the limits as provided by the IRS Code. The Company is not required to match employee contributions but may do so at its discretion. The Company made no contributions during the two years ended December 31, 2010.

[Table of Contents](#)**NOTE U—EARNINGS PER SHARE “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. For the years ended December 31, 2010 and 2009, diluted per share computations are not presented since this effect would be antidilutive.

The reconciliation of the numerator of the basic and diluted EPS calculations, due to the inclusion of preferred stock dividends, accretion, and gain on redemption, was as follows for the following fiscal years ended December 31:

	2010	2009
Numerator:		
Loss from continuing operations	\$ (649,772)	\$ (2,662,888)
Convertible preferred stock dividends, accretion, and gain on redemption	(643,759)	(518,749)
Loss from continuing operations applicable to common stockholders (basic and diluted EPS)	<u>\$ (1,293,531)</u>	<u>\$ (3,181,637)</u>

The following table summarizes the potential weighted average shares of common stock that were excluded from the diluted per share calculation, because the effect of including these potential shares was anti-dilutive.

	Years ended December 31,	
	2010	2009
Preferred Stock	10,185,667	31,708,030
Convertible Debt	2,419,597	20,218
Stock Options	<u>640,535</u>	<u>421,081</u>

Items excluded from the diluted per share calculation because the exercise price was greater than the average market price of the common shares:

	Years ended December 31,	
	2010	2009
Stock options	2,844,258	2,613,758
Warrants	10,261,615	16,775,791
Total	13,105,873	19,389,549

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NOTE V—Results by Quarter (Unaudited)

The following table presents selected unaudited financial information for the eight quarters in the period ended December 31, 2010. The results for any quarter are not necessarily indicative of future quarterly results and, accordingly, period-to-period comparisons should not be relied upon as an indication of future performance.

	For the Quarters Ended							
	March 31, 2009	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010	September 30, 2010	December 31, 2010
Revenue	\$ 538,194	\$ 280,685	\$ 524,351	\$ 1,014,052	\$ 976,175	\$ 1,433,051	\$ 546,376	\$ 564,806
Gross profit	401,115	212,254	329,565	910,113	866,075	1,329,210	340,206	425,776
Income (loss) from continuing operations	(789,813)	(890,407)	(794,172)	(188,496)	565,239	243,816	(931,697)	(527,130)
Income (loss) from discontinued operations	1,011,862	1,030,177	724,761	105,735	435,319	(9,050)	(12,093)	(71,193)
Gain (loss) on disposal of discontinued operations	—	—	—	4,483,902	—	—	—	—
Net income (loss)	\$ 222,049	\$ 139,770	\$ (69,411)	\$ 4,401,141	\$ 1,000,557	\$ 234,766	\$ (943,790)	\$ (598,322)
Basic and diluted earnings per common share:								
Income (loss) from continuing operations	\$ (0.02)	\$ (0.02)	\$ (0.01)	\$ (0.00)	\$ 0.01	\$ 0.00	\$ (0.01)	\$ (0.01)
Income (loss) from discontinued operations	0.02	0.02	0.01	0.00	0.00	0.00	0.00	(0.00)
Gain on disposal of discontinued operations	—	—	—	0.06	—	—	—	—
Net loss	\$ 0.00	\$ 0.00	\$ (0.00)	\$ 0.06	\$ 0.01	\$ 0.00	\$ (0.01)	\$ (0.01)
Weighted average shares outstanding:								
Basic and diluted	68,477,547	71,291,168	73,521,550	76,821,746	77,713,398	77,713,398	78,016,082	78,155,413

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BIO-KEY INTERNATIONAL, INC.

Date: March 23, 2011

By: /s/ MICHAEL W. DEPASQUALE
Michael W. DePasquale

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ MICHAEL W. DEPASQUALE</u> Michael W. DePasquale	Chief Executive Officer and Director	March 23, 2011
<u>/s/ CECILIA WELCH</u> Cecilia Welch	Chief Financial Officer, Principal Accounting Officer	March 23, 2011
<u>/s/ THOMAS J. COLATOSTI</u> Thomas J. Colatosti	Chairman of the Board of Directors	March 23, 2011
<u>/s/ JEFFREY J. MAY</u> Jeffrey J. May	Director	March 23, 2011
<u>/s/ CHARLES P. ROMEO</u> Charles P. Romeo	Director	March 23, 2011
<u>/s/ JOHN SCHOENHERR</u> John Schoenherr	Director	March 23, 2011

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EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
3.1 (1)	Certificate of Incorporation of BIO-key International, Inc., a Delaware corporation
3.2 (1)	Certificate of Designation of Series A 7% Convertible Preferred Stock of BIO-key International, Inc., a Delaware corporation
3.3 (1)	By-Laws of BIO-key International, Inc., a Delaware corporation
3.4 (11)	Certificate of Amendment of Certificate of Incorporation of BIO-key International, Inc., a Delaware corporation
3.5 (9)	Certificate of Designation of the Series B Convertible Preferred Stock of the Company
3.6 (12)	Certificate of Designation of the Series C Convertible Preferred Stock of the Company
3.7 (16)	Certificate of Designation of the Series D Convertible Preferred Stock of the Company
4.1 (2)	Specimen certificates for shares of BIO-key International, Inc. common stock
10.1 (3)	SAC Technologies, Inc. 1999 Stock Option Plan
10.2 (4)	Employment Agreement by and between BIO-key International, Inc. and Mira LaCous dated November 20, 2001
10.3 (5)	BIO-key International, Inc. 2004 Stock Incentive Plan
10.4 (5)	Warrant to purchase 230,000 shares of Common Stock issued to Jesup & Lamont Securities Corp. on March 31, 2004
10.5 (5)	Warrant to purchase 105,000 shares of Common Stock issued to Douglass Bermingham on March 31, 2004
10.6 (5)	Warrant to purchase 60,000 shares of Common Stock issued to Mason Sexton on March 31, 2004
10.7 (5)	Warrant to purchase 22,000 shares of Common Stock issued to David Moss on March 31, 2004
10.8 (5)	Warrant to purchase 22,000 shares of Common Stock issued to Patrick Gaynes on March 31, 2004
10.9 (5)	Warrant to purchase 5,000 shares of Common Stock issued to Tom DuHamel on March 31, 2004
10.10 (6)	Form of Common Stock Purchase warrant issued pursuant to the Securities Purchase Agreement, effective as of May 31, 2005, by and among the Company, The Shaar Fund, Ltd. and the other purchasers that are a party thereto
10.11 (7)	Form of Common Stock Purchase Warrant issued pursuant to the Securities Purchase Agreement, dated as of January 23, 2006, by and among the Company, The Shaar Fund Ltd., Longview Fund, L.P. and Longview Special Finance
10.12 (7)	Registration Rights Agreement, dated as of January 23, 2006 by and among the Company, The Shaar Fund, Ltd., Longview Fund, L.P. and Longview Special Finance
10.13 (10)	Securities Purchase Agreement, dated as of August 10, 2006, by and between the Company and Trellus Partners, L.P.
10.14 (10)	Form of Common Stock Purchase Warrant issued pursuant to the Securities Purchase Agreement, dated as of August 10, 2006, by and between the Company and Trellus Partners, L.P.
10.15 (10)	Registration Rights Agreement, dated as of August 10, 2006, by and between the Company and Trellus Partners, L.P.
10.16 (10)	Securities Purchase Agreement, dated as of August 10, 2006, by and between the Company and The Shaar Fund Ltd.
10.17 (12)	Purchase and Sale Agreement, dated as of May 22, 2007, by and between the Company and ZOLL Data Systems, Inc
10.18 (14)	Options to Purchase 50,000 and 65,241 Shares of Common Stock issued to Thomas J. Colatosti
10.19 (14)	Options to Purchase 100,000 and 130,481 Shares of Common Stock issued to Jeff May
10.20 (14)	Options to Purchase 50,000 and 32,620 Shares of Common Stock issued to Charles Romeo
10.21 (14)	Options to Purchase 50,000 and 48,930 Shares of Common Stock issued to John Schoenherr
10.22 (14)	Option to Purchase 500,000 Shares of Common Stock issued to Michael W. DePasquale
10.23 (14)	Option to Purchase 50,000 Shares of Common Stock issued to Thomas J. Colatosti

10.24 (14)	Options to Purchase 50,000 and 25,000 Shares of Common Stock issued to Jeff May
10.25 (14)	Option to Purchase 50,000 Shares of Common Stock issued to Charles Romeo
10.26 (14)	Option to Purchase 100,000 Shares of Common Stock issued to John Schoenherr
10.27 (15)	Settlement and Mutual Release Agreement, dated July 2, 2009, by and between the Company and Longview Special Finance, Inc., and Longview Fund LP
10.28 (15)	Promissory Note, dated July 7, 2009, by and between the Company and The Shaar Fund Ltd
10.29 (16)	Asset Purchase Agreement, dated August 13, 2009, by and between the Company and Interact911 Mobile Systems, Inc.

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10.30 (16)	Note Amendment and Extension Agreement, dated as of November 3, 2009, by and between the Company and The Shaar Fund Ltd
10.31 (16)	Securities Exchange Agreement, dated as of November 12, 2009, by and between the Company and The Shaar Fund Ltd., and Thomas J. Colatosti
10.32 (16)	Promissory Note, dated December 7, 2009, by and between the Company and InterAct911 Mobile Systems, Inc.
10.33 (16)	Warrant to purchase 8,000,000 shares of Common Stock issue to SilkRoad Equity, LLC on December 7, 2009
10.34 (16)	Warrant to purchase 4,750,000 shares of Common Stock issued to The Shaar Fund Ltd. on December 28, 2009
10.35 (16)	Warrant to purchase 250,000 shares of Common Stock issued to Thomas J. Colatosti on December 28, 2009
10.36 (16)	Convertible Note, dated as of December 28, 2009, by and between the Company and The Shaar Fund Ltd.
10.37 (16)	Convertible Note, dated as of December 28, 2009, by and between the Company and Thomas J. Colatosti
10.38 (16)	Compensation Agreement, dated January 12, 2010, by and between the Company and Mr. Colatosti
10.39 (16)	Employment Agreement, effective March 25, 2010, by and between the Company and Michael W. DePasquale
10.40 (8)	Omnibus Amendment and Waiver Agreement, dated as of December 30, 2010, by and between the Company and InterAct911 Mobile Systems, Inc. and SilkRoad Equity, LLC
10.41 (8)	Securities Exchange Agreement, dated as of December 31, 2010, by and between the Company and The Shaar Fund Ltd., and Thomas J. Colatosti
10.42 (8)	Security and Subordination Agreement, dated as of December 31, 2010, by and between the Company and The Shaar Fund Ltd., and Thomas J. Colatosti
10.43 (8)	Warrant to purchase 8,000,000 shares of Common Stock issued to The Shaar Fund Ltd. on December 31, 2010
10.44 (8)	Secured Note, dated as of December 31, 2010, by and between the Company and The Shaar Fund Ltd.
10.45 (8)	Secured Note, dated as of December 31, 2010, by and between the Company and Thomas J. Colatosti
21.1 (13)	List of subsidiaries of BIO-key International, Inc.
23.1 (8)	Consent of RMSBG P.C
23.2 (8)	Consent of CCR LLP
31.1 (8)	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2 (8)	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1 (8)	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2 (8)	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

- (1) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on January 5, 2005 and incorporated herein by reference.
- (2) Filed as an exhibit to the registrant's registration statement on Form SB-2, File No. 333-16451 dated February 14, 1997 and incorporated herein by reference.
- (3) Filed as an exhibit to the registrant's annual report on Form 10-KSB filed with the Securities and Exchange Commission on April 14, 2000 and incorporated herein by reference.
- (4) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on November 26, 2001 and incorporated herein by reference.
- (5) Filed as an exhibit to the registrant's registration statement on Form SB-2, File No. 333-120104 dated October 29, 2004 and incorporated herein by reference. Filed herewith.
- (6) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on June 14, 2005 and incorporated herein by reference.
- (7) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on January 25, 2006 and incorporated herein by reference.
- (8) Filed herewith.

- (9) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2006 and incorporated herein by reference.
- (10) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on August 16, 2006 and incorporated herein by reference.
- (11) Filed as an exhibit to the registrant's annual report on Form 10-KSB filed with the Securities and Exchange Commission on March 30, 2007 and incorporated herein by reference.
- (12) Filed as an exhibit to the registrant's current report on Form 8-K filed with the Securities and Exchange Commission on May 25, 2007 and incorporated herein by reference.
- (13) Previously filed
- (14) Filed as an exhibit to the registrant's annual report on Form 10-K filed with the Securities and Exchange Commission on March 11, 2009 and incorporated herein by reference.
- (15) Filed as an exhibit to the registrant's quarterly report on Form 10-Q filed with the Securities and Exchange Commission on November 13, 2009 and incorporated herein by reference.
- (16) Filed as an exhibit to the registrant's annual report on Form 10-K filed with the Securities and Exchange Commission on March 26, 2010 and incorporated herein by reference.

OMNIBUS AMENDMENT OF THE TRANSACTION DOCUMENTS RELATED TO THE SALE OF BIO-KEY'S LAW ENFORCEMENT DIVISION TO INTERACT AND ASSOCIATED WAIVERS

THIS OMNIBUS AMENDMENT AND WAIVER (this "**Amendment and Waiver**") is made and entered into as of December 30, 2010 by and between BIO-key International, Inc., a Delaware corporation ("**Seller**"), and InterAct911 Mobile Systems, Inc., a Delaware corporation ("**Buyer**"). Seller and Buyer are collectively referred to herein as the "**Parties**" and each individually as a "**Party**".

WHEREAS, Buyer and Seller are parties to that certain Asset Purchase Agreement dated as of August 13, 2009 (as amended, modified and/or supplemented to date, the "**Asset Purchase Agreement**").

WHEREAS, Buyer and Seller have agreed to an omnibus amendment and waiver with respect to the Transaction Documents (as defined in Section 1.1 of the Asset Purchase Agreement) executed to effectuate the sale of Seller's Law Enforcement Division to Buyer as set forth herein;

WHEREAS, Section 10.1 of the Asset Purchase Agreement stipulates that the Agreement may not be amended or modified except by an instrument in writing signed by or on behalf of Buyer and Seller or by a waiver in accordance with Section 10.2;

WHEREAS, Section 10.2 of the Asset Purchase Agreement addresses waiver and allows any Party to the Agreement to extend the time for the performance of any of the obligations or other acts of the other Parties as long as the waiver/extension is in writing and signed by the Party to be bound thereby;

NOW, THEREFORE, for good and valuable consideration, including the forfeiture of warrants previously issued to SilkRoad Equity LLC as set forth herein, the receipt and sufficiency of which are hereby

acknowledged, the Parties agree to the following Omnibus Amendment and Waiver as follows:

ARTICLE I
DEFINITIONS

1.1 Definitions

All definitions in the Asset Purchase Agreement remain unchanged. Capitalized terms used herein without definition have the meanings given to them in the Asset Purchase Agreement.

"**Deferred Payment**" is the \$834,000.00 [Eight Hundred and Thirty Four Thousand Dollars] which is the difference between the full payment due in December 2010 under the Buyer Note prior to this Amendment and Waiver and the amount paid by Buyer in December 2010.

ARTICLE II

Amendment—Payment Schedule

The payment schedule listed in the Buyer Note is amended such that the first payment of \$1,334,000 due on the first anniversary date of the Buyer Note (the "**2010 Payment Requirement**") is adjusted. Instead of requiring Buyer to pay the entire payment in one lump sum, Seller has agreed to accept installment payments of the \$1,334,000 over time as follows:

Seller accepted payment of \$500,000 on December 14, 2010;

This \$500,000 payment will be treated as principal curtailment;

Buyer will pay Seller the balance of the Deferred Payment due to Seller over the first three quarters of 2011 as follows:

Buyer will pay Seller \$278,000.00 on March 31, 2011;

Buyer will pay Seller \$278,000.00 on June 30, 2011;

Buyer will pay Seller \$278,000.00 on September 30, 2011;

These scheduled payments during the first, second and third quarters of 2011 (collectively, the "**2011 Installment Payments**") will also be treated as principal curtailment. There shall be no penalties for pre-payment of the scheduled payments outlined above. Buyer shall have three (3) Business Days to cure any failure to make any 2011 Installment Payment on the applicable due date set forth above.

This Amendment and Waiver does not in any way change the schedule of payments described in the Buyer Note due in December 2011 or December 2012.

Seller agrees to waive any Events of Default that have occurred or will occur with respect to the 2010 Payment Requirement (and not with respect to any other term or condition of the Buyer Note) until the final 2011 Installment Payment described above has been made on September 30, 2011; provided, however, that if any of the 2011 Installment Payments described above are not timely made, this Article II of this Amendment and Waiver shall terminate and be of no further force or effect and Seller shall be entitled to all of its rights and remedies under the Transaction Documents with respect to the Buyer Note.

Seller agrees that given the foregoing waiver, it does not have the right to enforce any acceleration provisions or other penalties that may be contained in the Transaction Documents solely with respect to the 2010 Payment Requirement and subject in all respects to the proviso contained in the preceding sentence.

Seller agrees to release InterAct911 and SilkRoad Equity LLC from any obligations under their Guaranties as contained in the Transaction

Documents pertaining to ensuring that Buyer made the full 2010 Payment Requirement in December 2010; provided, however, that such Guaranties remain in full force as to ensuring that Buyer makes the 2011 Installment Payments and fulfills each other obligation under the Buyer Note on a timely basis.

ARTICLE III

Payment of Interest

This Amendment and Waiver does not change the interest rates identified in the Buyer Note. Specifically, the following provision shall remain in effect:

“All amounts not paid when due under this Note shall bear interest until paid at a rate of twelve percent (12%) per year or the maximum rate allowed by law, whichever is less.”

The Buyer Note is amended such that the interest on the Deferred Payment under this Amendment and Waiver shall not be “immediately due and payable”.

The Buyer Note is amended such that interest on the Deferred Payment of \$834,000.00 [Eight Hundred and Thirty Four Thousand Dollars] (which, for purposes of clarity, shall be equal to twelve percent (12%) per year) shall be paid pursuant to the payment schedule listed in the Buyer Note for regular interest payments. Under that schedule, the interest payments on the Deferred Payments shall be payable quarterly in arrears in cash on January 1, April 1, July 1 and October 1 of 2011.

ARTICLE IV

Amendment—Acceleration Clause pertaining to Buyer Raising Private Capital

The Buyer Note is amended to delete item (g) under the listing of Events of Default which states that “Maker shall receive proceeds from equity capital financings after the date of the Note that collectively exceed Twenty Million Dollars (\$20,000,000).

The Buyer Note is amended to state that Buyer does not have any limitation related to receiving proceeds from private (non-IPO) equity capital financings for the remainder of the term of the Note and the receipt of such funds no longer constitutes an event that would allow Seller to accelerate the payment of the principal and/or interest on the Note.

Notwithstanding the above, should Buyer (collectively with the Parent and its other Affiliates) raise more than Twenty Million Dollars (\$20,000,000) of new capital in the aggregate from private (non-IPO) equity capital financings, excluding debt and any equity issued upon the conversion of debt, from and after the date of the Buyer Note and prior to paying off the Buyer Note in full, then Buyer shall be required to make a Seven Hundred and Fifty Thousand Dollar (\$750,000.00) payment, payable within five (5) days of closing on such funding. This payment shall be treated as principal curtailment and applied towards the unpaid principal balance of the Buyer Note in the inverse order of maturity.

ARTICLE V

Forfeiture of SilkRoad Equity LLC Warrants to Seller

The Transaction Documents include the Warrant issued at the Closing giving SilkRoad Equity LLC (“**SilkRoad**”) the right to purchase up to 8,000,000 Shares of Common Stock of Seller.

Section 12 of the Warrant states that any term may be, “. . .changed, waived, discharged or terminated only by an instrument in writing

signed by the party against which enforcement of such change, waiver, discharge or termination is sought.”

It is agreed between the Buyer and Seller that in consideration of amendments and waivers described herein, SilkRoad shall forfeit its Warrant to purchase 8,000,000 shares of Common Stock of Seller. Upon the execution of this Amendment and Waiver by both Parties, the Warrant will automatically terminate and become null and void.

ARTICLE VI

Conflicts Between Transaction Documents and this Amendment and Waiver

To the extent that this Amendment and Waiver conflicts with any provisions in any of the Transaction Documents, this Amendment and Waiver will control/govern.

Except as expressly set forth in this Amendment and Waiver, no other term or provision of the Buyer Note or any of the other Transaction Documents is hereby amended or affected in any way, and each such document shall remain in full force and effect after the date hereof.

This Amendment and Waiver shall be governed by and construed in accordance with the laws of the State of Delaware, without regard to principles of conflicts of laws.

[Signature page follows]

Acknowledged and Accepted:

BIO-KEY INTERNATIONAL, INC.

By: _____

Name:

Title:

STATE OF NEW JERSEY

COUNTY OF

BEFORE ME, the undersigned authority, on this day personally appeared _____ (title) of _____, known by me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he/she executed the same for the purpose and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE ON _____, 2010

Notary Public for the State of New Jersey

[NOTORIAL SEAL]

Acknowledged and Accepted:

INTERACT911 MOBILE SYSTEMS, INC.

By: _____

Name:

Title:

STATE OF

COUNTY OF

BEFORE ME, the undersigned authority, on this day personally appeared _____ (title) of _____, known by me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he/she executed the same for the purpose and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE ON _____, 2010

Notary Public for the Commonwealth of _____

[NOTORIAL SEAL]

Acknowledged and Accepted (solely
with respect to Article V hereof):

SILKROAD EQUITY, LLC

By: _____
Name:
Title:

STATE OF
COUNTY OF

BEFORE ME, the undersigned authority, on this day personally appeared _____ (title) of _____, known by me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he/she executed the same for the purpose and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE ON _____, 2010

Notary Public for the Commonwealth of _____

[NOTORIAL SEAL]

SECURITIES EXCHANGE AGREEMENT

This Securities Exchange Agreement (this "**Agreement**") is entered into as of December 31, 2010 by and among BIO-key International, Inc., a Delaware corporation (the "**Company**"), The Shaar Fund, Ltd. ("**Shaar**") and Thomas J. Colatosti ("**TJC**") and, together with Shaar, collectively the "**Holders**" and each individually a "**Holder**").

Introduction

Shaar is the holder of 27,932 shares (the "**Shaar Exchanged Shares**") of the Company's Series D 7% Convertible Preferred Stock, \$0.0001 par value per share (the "**Series D Preferred Stock**"). TJC is the holder of 2,625 shares (the "**TJC Exchanged Shares**") and, together with the Shaar Exchanged Shares, collectively the "**Exchanged Shares**") of Series D Preferred Stock.

Shaar is also the holder of a Seven Percent (7%) Convertible Promissory Note dated December 28, 2009 issued by the Company to Shaar in the original principal amount of \$673,079 (the "**Shaar Exchanged Note**") and TJC is the holder of a Seven Percent (7%) Convertible Promissory Note dated December 28, 2009 issued by the Company to TJC in the original principal amount of \$64,878 (the "**TJC Exchanged Note**") and, together with the Shaar Exchanged Note, collectively the "**Exchanged Notes**").

Shaar is also the holder of (i) a Warrant dated January 23, 2006 to purchase up to 225,000 shares of the Company's common stock, \$0.0001 par value per share ("**Common Stock**"), (ii) a Warrant dated August 10, 2006 to purchase up to 133,333 shares of Common Stock and (iii) a Warrant dated December 28, 2009 to purchase up to 4,750,000 shares of Common Stock (collectively, the "**Shaar Exchanged Warrants**").

The Holders and the Company desire to exchange the Exchanged Shares, including all accrued and unpaid dividends thereon to and including the Closing Date (as defined below), and the Exchanged Notes for the Secured Notes (as defined below) and, in the case of Shaar, the Shaar Exchanged Warrants for the New Shaar Warrant (as defined below), in each case on the terms and conditions set forth in this Agreement.

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants contained herein, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto agree as follows:

1. Exchange of the Exchanged Shares, Exchanged Notes and Shaar Exchanged Warrants for the Secured Notes and the New Shaar Warrant.

1.1. **Authorization of the Secured Notes.** The Company has authorized the issuance of Seven Percent (7%) Secured Promissory Notes, each to be in the form attached as **Exhibit A** hereto, in the respective original principal amounts set forth on **Schedule I** attached hereto (collectively, the "**Secured Notes**") to Shaar and TJC on the terms and conditions set forth in

this Agreement. Each Holder hereby consents to the issuance of his or its Secured Note, and the indebtedness represented thereby, on the terms and conditions set forth in this Agreement.

1.2 **Authorization of the New Shaar Warrant.** The Company has authorized the issuance of a Warrant to purchase up to 8,000,000 shares of Common Stock, in the form attached hereto as **Exhibit B** (the "**New Shaar Warrant**"), to Shaar on the terms and conditions set forth in this Agreement.

1.3 **The Exchange.**

(a) In exchange for the delivery by Shaar of the Shaar Exchanged Shares, the Shaar Exchanged Note and the Shaar Exchanged Warrants, the Company agrees, in full settlement of the Company's obligations to Shaar as of the Closing Date under the Series D Certificate of Designation (as defined below), the Shaar Exchanged Shares, the Shaar Exchanged Note and the Shaar Exchanged Warrants, to issue and deliver to Shaar its Secured Note, the Security Agreement, as defined below, and the New Shaar Warrant (the "**Shaar Exchange**").

(b) In exchange for the delivery by TJC of the TJC Exchanged Shares and the TJC Exchanged Note, the Company agrees, in full settlement of the Company's obligations to TJC as of the Closing Date under the Series D Certificate of Designation, the TJC Exchanged Shares and the TJC Exchanged Note, to issue and deliver to TJC his Secured Note and the Security Agreement (the "**TJC Exchange**") and, together with the Shaar Exchange, the "**Exchange**").

(c) Other than as set forth in this Agreement, the Exchange shall be made without any additional consideration payable to or by the Holders or the Company. As used herein, "**Series D Certificate of Designation**" means the Certificate of Designation of the Company filed with the Secretary of State of the State of Delaware on December 28, 2009, which provides for the designation of the rights and preferences of the Series D Preferred Stock.

1.4 **Closing.** The closing of the Exchange on the terms and conditions set forth in this Agreement (the "**Closing**") shall take place remotely via the exchange of documents and signatures at 10:00 a.m. EST on (a) the later of December 31, 2010 or the date that is five (5) days after the satisfaction or waiver of all of the conditions set forth in Section 4 hereof or (b) on such other date as the parties hereto may agree (the "**Closing Date**").

(a) At the Closing, (i) the Company shall deliver to each Holder (A) its or his Secured Note and the Security Agreement, and (B) in the case of Shaar, its New Shaar Warrant and (ii) each Holder shall deliver to the Company (A) stock certificate(s) representing its or his Exchanged Shares, together with a duly executed transfer power transferring its or his Exchanged Shares to the Company for cancellation, (B) its or his original Exchanged Note, together with a duly executed transfer power transferring its or his Exchanged Note to the Company for cancellation, and (C) in the case of Shaar, its Shaar Exchanged Warrants.

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(b) At the Closing, the Company will make a cash payment to Shaar in the amount of \$500,000 by wire transfer of immediately available funds to an account designated by Shaar prior to the Closing.

(c) On January 31, 2011, the Company will make a cash payment to Shaar in the amount of \$125,209 by wire transfer of immediately available funds to the account designated by Shaar pursuant to Section 1.5(b) above. The parties hereto acknowledge and agree that such amount represents the full satisfaction of the Company's obligations to Shaar pursuant to all accrued and unpaid dividends with respect to the Company's Series B Convertible Preferred Stock and Series C Convertible Preferred Stock and that, upon its receipt of such payment, Shaar shall not have any further rights to any such dividends.

2. Representations and Warranties of the Holder. Each Holder, severally and not jointly, represents and warrants to the Company as follows:

2.1. Title. Such Holder has good title to his or its Exchanged Shares and Exchanged Note, and, in the case of Shaar, the Shaar Exchanged Warrants, free and clear of any and all restrictions, encumbrances, liens, rights, title or interests of others, other than restrictions under applicable securities laws.

2.2. Authority. Such Holder has the requisite power and authority to enter into this Agreement and to consummate the transactions contemplated hereby and to deliver his or its Exchanged Shares and Exchanged Note and, in the case of Shaar, the Shaar Exchanged Warrants, to the Company in accordance herewith.

3. Representations and Warranties of the Company. The Company represents and warrants to each Holder as follows:

3.1. Entity Matters. The Company is duly organized and validly existing in good standing under the laws of the State of Delaware, has all requisite power and authority to conduct its business and to own its property as the same is and shall be conducted or owned, and is qualified to do business as a foreign corporation in all locations required under the laws of each jurisdiction in which it does business and under which the failure so to qualify and remain in good standing would have a material adverse effect on the Company. The execution of this Agreement, the Secured Notes, the Security and Subordination Agreement dated as of even date herewith made by the Company in favor of Shaar, TJC and The Shaar Fund, Ltd., as collateral agent thereunder (the "**Security Agreement**"), and the New Shaar Warrant (collectively, the "**Exchange Documents**") will not violate the Company's Certificate of Incorporation or By-Laws.

3.2. No Violation. The performance by the Company of its obligations hereunder or under any other Exchange Document does not constitute a violation of any law, order, regulation, contract, or agreement to which the Company is a party or by which the Company or the Company's property may be bound and does not require any filing or registration with, or any permit, license, consent, or approval of, any governmental agency or regulatory authority, or the waiver, consent or approval of any other party which has not been or will not be duly obtained as of the Closing Date.

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3.3. No Litigation. There is no litigation or arbitration pending or, to the Company's knowledge, threatened against the Company which, if adversely decided, could materially impair the ability of the Company to pay and perform the Company's obligations under any Exchange Document.

3.4. Exchange Documents Enforceable. The Exchange Documents have been duly authorized, executed, and delivered by the Company and are legal, valid, and binding instruments, enforceable against the Company in accordance with their respective terms, except as limited by applicable bankruptcy, insolvency, reorganization, moratorium or other laws of general application affecting enforcement of creditors' rights and general principles of equity that restrict the availability of equitable or legal remedies.

4. Conditions Precedent to the Holders' Obligations. It shall be a condition precedent to the Holders' obligations under this Agreement that all of the following requirements are satisfied:

4.1. Representations and Warranties. All representations and warranties made by or on behalf of the Company herein shall be true, correct and complete in all material respects on and as of the Closing Date.

4.2. Additional Conditions Precedent. Each Holder shall have received each of the following, as applicable:

- (a) its or his Secured Note executed and delivered by the Company in favor of such Holder;
- (b) a copy of the Security Agreement executed and delivered by the Company in favor of the agent thereunder;
- (c) in the case of Shaar, the New Shaar Warrant executed and delivered by the Company; and
- (d) such other and further documents, agreements and instruments as the Holders or their counsel may reasonably require to evidence, confirm or give effect to the undertakings of the Company set forth herein.

5. Miscellaneous.

5.1. Governing Law. THIS AGREEMENT AND EACH OTHER EXCHANGE AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF NEW YORK, WITHOUT REGARD TO PRINCIPLES OF CONFLICTS OF LAWS. ANY ACTION BROUGHT BY ANY PARTY AGAINST ANOTHER CONCERNING THE TRANSACTIONS CONTEMPLATED BY THIS AGREEMENT AND EACH OTHER EXCHANGE AGREEMENT SHALL BE BROUGHT ONLY IN THE STATE COURTS OF NEW YORK OR IN THE FEDERAL COURTS LOCATED IN THE STATE OF NEW YORK, IN EACH CASE SITTING IN THE CITY OF NEW YORK, BOROUGH OF MANHATTAN. ALL PARTIES AND THE INDIVIDUALS EXECUTING THIS AGREEMENT AND THE OTHER EXCHANGE AGREEMENTS ON

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BEHALF OF THE COMPANY AGREE TO SUBMIT TO THE JURISDICTION OF SUCH COURTS AND WAIVE TRIAL BY JURY. IN THE EVENT THAT ANY PROVISION OF THIS AGREEMENT OR ANY OTHER EXCHANGE AGREEMENT DELIVERED IN CONNECTION HERewith IS INVALID OR UNENFORCEABLE UNDER ANY APPLICABLE STATUTE OR RULE OF LAW, THEN SUCH PROVISION SHALL BE DEEMED INOPERATIVE TO THE EXTENT THAT IT MAY CONFLICT THEREWITH AND SHALL BE DEEMED MODIFIED TO CONFORM WITH SUCH STATUTE OR RULE OF LAW. ANY SUCH PROVISION WHICH MAY PROVE INVALID OR UNENFORCEABLE UNDER ANY LAW SHALL NOT AFFECT THE VALIDITY OR ENFORCEABILITY OF ANY OTHER PROVISION OF THIS AGREEMENT OR ANY OTHER EXCHANGE AGREEMENT.

5.2. Survival. The representations, warranties, covenants and agreements made herein shall survive any investigation made by the Holders and for one year after the date of the closing of the transactions contemplated hereby. All statements as to factual matters contained in any certificate or other instrument delivered by or on behalf of the Company pursuant hereto in connection with the transactions contemplated hereby shall be deemed to be representations and warranties by the Company hereunder solely as of the date of such certificate or instrument, unless otherwise specified therein.

5.3. Successors. Except as otherwise expressly provided herein, the provisions hereof shall inure to the benefit of, and be binding upon, the successors, heirs, executors and administrators of the parties hereto. No Holder may assign its rights hereunder to a competitor of the Company. The Company may not assign its rights or delegate its obligations hereunder to a third party without obtaining the consent of the Holders, such consent not to be unreasonably withheld or delayed.

5.4. Entire Agreement. This Agreement, the other Exchange Documents, the exhibits and schedules hereto and thereto and the other documents delivered pursuant hereto constitute the full and entire understanding and agreement between the parties with regard to the subjects hereof and no party shall be liable or bound to any other in any manner by any representations, warranties, covenants and agreements except as specifically set forth herein and therein.

5.5. Amendments and Waivers. This Agreement may be amended or modified only upon the written consent of the Company and each Holder.

5.6. Delays or Omissions. It is agreed that no delay or omission to exercise any right, power or remedy accruing to any party, upon any breach, default or noncompliance by another party under this Agreement or the other Exchange Documents, shall impair any such right, power or remedy, nor shall it be construed to be a waiver of any such breach, default or noncompliance, or any acquiescence therein, or of or in any similar breach, default or noncompliance thereafter occurring. All remedies, either under this Agreement or the other Exchange Documents, by law or otherwise afforded to any party, shall be cumulative and not alternative.

5.7. Notices. All notices and other communications given or made pursuant to this Agreement shall be in writing and shall be deemed effectively given upon the earlier of actual

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receipt or: (a) personal delivery to the party to be notified, (b) when sent, if sent by electronic mail or facsimile during normal business hours of the recipient, and if not sent during normal business hours, then on the recipient's next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) business day after deposit with a nationally recognized overnight courier, freight prepaid, specifying next business day delivery, with written verification of receipt. All communications shall be sent to the respective parties at the following addresses or to such other e-mail address, facsimile number or address as subsequently modified by written notice given in accordance with this Section:

If to the Company or to TJC,
to: or c/o

BIO-key International, Inc.
3349 Highway 138

Building D, Suite B
Wall, NJ 07719
Attn: Chief Executive Officer
Facsimile: (732) 359-1101

with a copy (which shall not
constitute notice) to:

Choate, Hall & Stewart LLP
Two International Place
Boston, MA 02110
Attention: Charles J. Johnson, Esq.
Facsimile: (617) 248-4000

If to Shaar, to:

The Shaar Fund Ltd.
c/o Maarten Robberts
SS&C Fund Services N.V.
Pareraweg 45
Curacao, Netherlands Antilles
Facsimile: (599-9) 434-3560

with a copy (which shall not
constitute notice) to:

Meltzer, Lippe, Goldstein & Breitstone, LLP
190 Willis Avenue
Mineola, NY 11501
Attention: Ira R. Halperin, Esq.
Facsimile: (516) 747-0653

5.8. Titles and Subtitles. The titles of the sections and subsections of this Agreement are for convenience of reference only and are not to be considered in construing this Agreement.

5.9. Facsimile Signatures; Counterparts. This Agreement may be executed by facsimile signatures and in any number of counterparts, each of which shall be an original, but all of which together shall constitute one instrument.

5.10. Broker's Fees. Each party hereto represents and warrants that no agent, broker, investment banker, person or firm acting on behalf of or under the authority of such party hereto is or will be entitled to any broker's or finder's fee or any other commission directly or indirectly in connection with the transactions contemplated herein. Each party hereto further agrees to

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indemnify each other party for any claims, losses or expenses incurred by such other party as a result of the representation by such party in this Section 5.10 being untrue.

5.11. Construction. Each party acknowledges that its legal counsel participated in the preparation of this Agreement and the other Exchange Documents and, therefore, stipulates that the rule of construction that ambiguities are to be resolved against the drafting party shall not be applied in the interpretation of this Agreement to favor any party against the other.

5.12. Fees and Expenses. The Company agrees to pay the reasonable fees and expenses of Meltzer, Lippe, Goldstein & Breitstone, LLP, as counsel to Shaar, in connection with the negotiation, execution and delivery of this Agreement, the Secured Notes, the Security Agreement and the New Shaar Warrant, and the consummation of the transactions contemplated hereby and thereby.

[Signature pages follow]

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IN WITNESS WHEREOF, each of the parties hereto has executed this Agreement as a sealed instrument as of the date first written above.

THE COMPANY:

BIO-KEY INTERNATIONAL, INC.

By: _____

Name: _____

[Signature Page to Securities Exchange Agreement]

THE HOLDERS:

THE SHAAR FUND, LTD.

By: SS&C Fund Services N.V.

By: _____
Name:
Title:

Thomas J. Colatosti

[Signature Page to Securities Exchange Agreement]

Exhibit A

Form of Secured Notes

Exhibit B

Form of New Shaar Warrant

Schedule I

Holder		Original Principal Amount
The Shaar Fund, Ltd.	\$	3,157,759
Thomas J. Colatosti	\$	350,804

SECURITY AND SUBORDINATION AGREEMENT

This Security and Subordination Agreement dated as of December 31, 2010 is made by BIO-key International, Inc., a Delaware corporation (the "**Debtor**" or the "**Company**"), in favor of The Shaar Fund, Ltd. ("**Shaar**"), Thomas J. Colatosti ("**Colatosti**") (each a "**Noteholder**" and collectively, the "**Noteholders**"), and The Shaar Fund, Ltd., as collateral agent (the "**Agent**") for the Noteholders (each of the Agent and each Noteholder being a "**Secured Party**" and the Agent and the Noteholders being collectively, the "**Secured Parties**").

Introduction

Pursuant to the Seven Percent (7%) Secured Promissory Notes of even date herewith (each, a "**Note**" and collectively, the "**Related Notes**") issued by the Debtor to Shaar and Colatosti, respectively, the Noteholders have agreed to extend credit to the Debtor upon the terms and subject to the conditions set forth therein. It is a condition precedent to the obligation of each Noteholder to extend such credit to the Debtor under its respective Related Note that the Debtor and the Secured Parties shall have executed and delivered this Security and Subordination Agreement.

NOW, THEREFORE, in consideration of the premises and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, and to induce the Noteholders to extend credit to the Debtor under the Related Notes, the parties hereby agree as follows:

1. Defined Terms. Unless otherwise defined herein, terms which are defined in the Related Notes and used herein are so used as so defined, and terms which are defined in the Uniform Commercial Code in effect in the State of New York on the date hereof are used herein as therein defined, and the following terms shall have the following meanings:

"**Code**" means the Uniform Commercial Code as from time to time in effect in the State of New York.

"**Collateral**" shall have the meaning assigned to it in Section 2 of this Security Agreement.

"**Event of Default**" shall have the meaning assigned to it in Section 8 of this Security Agreement.

"**Obligations**" means (a) the unpaid principal amount of, and interest on, and all fees, expenses and other amounts payable under or in respect of, the Related Notes, and (b) all other obligations of Debtor under and pursuant to this Agreement.

"**Security Agreement**" means this Security and Subordination Agreement, as amended or restated from time to time.

"**Senior Debt**" means the Note in favor of Shaar (the "**Senior Lender**"), including all principal, interest (including any interest accruing after commencement of a bankruptcy or similar proceeding) thereon, and any modification, extension, removal, refunding or refinancing of the foregoing, and all fees, expenses and other amounts payable under or in respect of the Note and this Agreement.

"**Subordinated Debt**" means the Note in favor of Colatosti (the "**Subordinated Holder**"), including all principal, interest (including any interest accruing after commencement of a bankruptcy or similar proceeding) thereon, and any modification, extension, removal, refunding or refinancing of the foregoing, and all fees, expenses and other amounts payable under or in respect of the Note and this Agreement.

2. Grant of Security Interest. As security for the due and punctual payment and performance of the Obligations, the Debtor hereby grants to the Agent, for the benefit of the Secured Parties, a continuing security interest in and lien on all of the Debtor's right, title and interest in and to all tangible and intangible property and assets of the Debtor, whether now owned or existing or hereafter acquired or arising, together with any and all additions and accessions thereto and replacements therefor and proceeds and products thereof and supporting obligations relating thereto (collectively referred to for purposes of this Section 2 as "**Collateral**"), including without limitation the property described below:

(a) all property coming into the possession, control or custody of, or in transit to, the Agent or any agent or bailee for the Agent, by or for the account of the Debtor, whether expressly as collateral security or for any other purpose, including, without limitation, all property left with the Agent, whether held in a general or special account or for safekeeping or otherwise, and including, but not limited to, cash, negotiable instruments, documents of title, chattel paper, securities of any type and/or description coming into the possession and/or control of the Agent in any way (including all dividends, interest, or other rights in connection with any such securities), certificates of deposit, deposit accounts, other accounts, interest or dividends thereon, other cash equivalents, supporting obligations and the products and proceeds therefrom;

(b) all tangible personal property, including without limitation all present and future Goods, Inventory (including, without limitation, all merchandise, raw materials, work in process, finished goods and supplies), machinery, Equipment, motor vehicles, rolling stock, tools, furniture, Fixtures, office supplies, computers, computer software and associated equipment, whether now owned or hereafter acquired, including, without limitation, all tangible personal property used in the operation of the business of the Debtor;

(c) all rights under all present and future authorizations, permits, licenses and franchises issued, granted or licensed to the Debtor for the operation of its business;

- (e) all rights under all present and future leases of real and personal property;
- (f) all Chattel Paper, including electronic and tangible chattel paper;
- (g) all Instruments, including promissory notes;
- (h) all Documents;
- (i) all Letter of Credit Rights;
- (j) all commercial tort claims and consumer goods; and

all other personal property, including, without limitation, all present and future Accounts, control accounts, cash, cash equivalents, deposits, deposit accounts, loss carry back, tax refunds, insurance policies and proceeds, premiums, rebates and refunds, choses in action, Investment Property, including Certificated and Uncertificated Securities and Security Entitlements, partnership interests, limited liability company interests, contracts, contract rights, General Intangibles (including without limitation, Payment Intangibles and Software, all customer and advertiser mailing lists, intellectual property, intellectual property licenses, patents, copyrights, trademarks, trade secrets, trade names, domain names, goodwill, customer lists, advertiser lists, catalogs and other printed materials, publications, indexes, lists, data and other documents and papers relating thereto, blueprints, designs, charts, and research and development, whether on paper, recorded electronically or otherwise), all websites (including without limitation, all content, HTML documents, audiovisual material, software, data, hardware, access lines, connections, copyrights, trademarks, patents and trade secrets relating to such websites) and domain names, any information stored on any medium, including electronic medium, related to any of the personal property of such Debtor, all financials books and records and other books and records relating, in any manner, to the business of such Debtor, all proposals and cost estimates and rights to performance, all instruments and promissory notes, documents and chattel paper, and all debts, obligations and liabilities in whatever form owing to such Debtor from any person, firm or corporation or any other legal entity, whether now existing or hereafter arising, nor or hereafter received by or belonging or owing to such Debtor; and all guaranties and security therefor, and all letters of credit and other supporting obligations in respect of such debts, obligations and liabilities.

3. Rights of Secured Parties; Limitations on Secured Parties' Liability.

(a) Debtor Remains Liable. Anything herein to the contrary notwithstanding, the Debtor shall remain liable under each item of Collateral to observe and perform all the conditions and obligations to be observed and performed by them thereunder, all in accordance with the terms of any agreement with respect thereto. The Secured Parties shall not have any obligation or liability under any item of Collateral (or any agreement with respect thereto) by reason of or arising out of this Security Agreement or the receipt by the Secured Parties of any payment relating to an item of Collateral pursuant hereto, nor shall the Secured Parties be obligated in any manner to perform any of the obligations of the Debtor under or pursuant to any item of Collateral (or any agreement with respect thereto), to make any payment, to make any

inquiry as to the nature or the sufficiency of any payment received by it or as to the sufficiency of any performance by any party under item of Collateral (or any agreement with respect thereto), to present or file any claim, to take any action to enforce any performance or to collect the payment of any amounts which may have been assigned to it or to which it may be entitled at any time or times.

(b) Notice to Account Debtors. Upon the request of the Agent at any time after the occurrence and during the continuance of an Event of Default, the Debtor shall notify account debtors with respect to the Collateral that the Collateral has been assigned to the Agent for the benefit of the Secured Parties and that payments in respect thereof shall be made directly to the Agent. The Agent may at any time, in its own name or in the name of others, communicate with account debtors with respect to the Collateral to verify with them to its satisfaction the existence, amount and terms of any item of Collateral.

(c) Collections. The Agent hereby authorizes the Debtor to collect all items of Collateral, and the Agent may curtail or terminate said authority at any time after the occurrence and during the continuance of an Event of Default. If required by the Agent at any time after the occurrence and during the continuance of an Event of Default, any payments on or with respect to any item of Collateral, when collected by the Debtor, shall be forthwith (and, in any event, within two business days) delivered by the Debtor to the Agent, in the exact form received, duly endorsed by the Debtor to the Agent or, if required by the Agent, deposited by the Debtor in a special collateral account maintained by the Agent, subject to withdrawal by the Agent only, as hereinafter provided, and, until so delivered or deposited, shall be held by the Debtor in trust for the Agent, segregated from other funds or assets of the Debtor. All Proceeds constituting collections of any item of Collateral while held by the Agent (or by the Debtor in trust for the Agent) shall continue to be collateral security for all of the Obligations and shall not constitute payment thereof until applied thereto by the Agent. If an Event of Default shall have occurred and be continuing, at any time at the Agent's election, the Agent may apply all or any part of the property so delivered or the funds so deposited on account of the Obligations in such order as the Agent may elect, and any part of such property or funds which the Agent elects not to apply and deems not required as collateral security for the Obligations shall be paid over from time to time by the Agent to the Debtor or to whomsoever may be lawfully entitled to receive the same. At the

Agent's request, the Debtor shall deliver to the Agent on behalf of the Secured Parties all original and other documents evidencing, and relating to, the agreements and transactions which gave rise to any item of Collateral, including, without limitation, all original orders, invoices and shipping receipts and original executed agreements, instruments and documents.

(d) Trust Account. Upon the occurrence and during the continuance of an Event of Default, the Agent may, in its sole discretion, elect to require the Debtor to establish with the Agent a trust account or lockbox account and to instruct all account Debtor to make payments with respect to all items of Collateral directly to such trust account or lockbox account. Following such election, the Debtor will collect all payments due with respect to all items of Collateral as the Agent's collection agent, hold such collections in trust for the Agent without commingling the same with other funds of the Debtor and will promptly, on the day of receipt thereof, transmit such collections to the Agent in the identical form in which they were received

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by the Debtor, with such endorsements as may be appropriate, accompanied by a report, in form approved by the Agent, showing the amount of such collections and the cash discounts applicable thereto.

(e) Title to Collateral. The Debtor represents and warrants to the Secured Parties that it has good title to all of the Collateral, free and clear of all liens, security interests and adverse interests.

4. Covenants. The Debtor covenants and agrees with the Agent and each Secured Party that, from and after the date of this Security Agreement until all Obligations are paid in full:

(a) Indemnification. The Debtor agrees to pay, and to save the Secured Parties harmless from, any and all liabilities, reasonable costs and expenses (including, without limitation, legal fees and expenses) (i) with respect to, or resulting from, any delay in paying, any and all excise, sales or other taxes which may be payable or determined to be payable with respect to any of the Collateral, (ii) with respect to, or resulting from, any delay in complying with any law, rule, regulation or order of any court, arbitrator or governmental entity, jurisdiction or authority applicable to any of the Collateral or (iii) in connection with any of the transactions contemplated by this Security Agreement. In any suit, proceeding or action brought by any Secured Party under any item of Collateral for any sum owing thereunder, or to enforce any provisions of any item of Collateral, the Debtor will save, indemnify and keep the Secured Parties harmless from and against all expense, loss or damage suffered by reason of any defense, setoff, counterclaim, recoupment or reduction or liability whatsoever of the account debtors or obligor thereunder, arising out of a breach by the Debtor of any obligation thereunder or arising out of any other agreement, indebtedness or liability at any time owing to or in favor of such account debtors or obligor or its successors from the Debtor. The foregoing indemnification shall not apply to any liabilities, costs or expenses resulting directly from the gross negligence or willful misconduct of the Secured Parties.

(b) Maintenance of Records. The Debtor will keep and maintain at its own cost and expense satisfactory and complete records of the Collateral, including without limitation, a record of all payments received and all credits granted with respect to all items of Collateral. For the Secured Parties' further security, the Debtor hereby grants to the Agent, for the benefit of the Secured Parties, a security interest in all of the Debtor's books and records pertaining to the Collateral, and upon the occurrence and during the continuance of an Event of Default, the Debtor shall turn over any such books and records to the Agent or to its representative at the request of the Agent.

(c) Right of Inspection. The Agent shall at all times have full and free access during normal business hours, and upon reasonable prior notice, to all the books of record and account of the Debtor, and the Agent or its representatives may examine the same, take extracts therefrom and make photocopies thereof, and the Debtor agrees to render to the Agent, at the Debtor's cost and expense, such clerical and other assistance as may be reasonably requested with regard thereto. The Agent and its representatives shall at all times also have the right during normal business hours, and upon reasonable prior notice, to enter into and upon any premises

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where any of the Collateral is located for the purpose of inspecting the same or otherwise protecting its interests therein.

(d) Compliance with Laws, etc. The Debtor will comply in all material respects with all laws, rules, regulations and orders of any court, arbitrator or governmental entity, jurisdiction or authority applicable to the Collateral or any part thereof or to the operation of the Debtor's business; *provided, however*, that the Debtor may contest any such law, rule, regulation or order in any reasonable manner which shall not, in the reasonable opinion of the Agent, adversely affect the Secured Parties' rights or the priority of the Agent's liens on the Collateral.

(e) Payment of Obligations. The Debtor will pay promptly when due all taxes, assessments and governmental charges or levies imposed upon the Collateral or in respect of its income or profits therefrom, as well as all claims of any kind (including, without limitation, claims for labor, materials and supplies) against or with respect to the Collateral, except that no such charge need be paid if (i) the validity thereof is being contested in good faith by appropriate proceedings, (ii) such proceedings do not involve any material danger of the sale, forfeiture or loss of any of the Collateral or any interest therein and (iii) such charge is adequately reserved against on the Debtor's books in accordance with U.S. generally accepted accounting principles.

(f) Limitation on Liens on Collateral. The Debtor will not create, incur or permit to exist, will defend the Collateral against, and will take such other action as is necessary to remove any lien, security interest, pledge, mortgage, deed of trust, levy, attachment, claim or other charge or encumbrance on or to the Collateral, other than the security interest in favor of the Agent pursuant to this Security Agreement,

and will defend the right, title and interest of the Agent in and to any of the Collateral against the claims and demands of all persons or entities whatsoever.

(g) Limitations on Dispositions of Collateral. The Debtor will not sell, transfer, lease or otherwise dispose of any of the Collateral, or remove or permit the Collateral to be removed from the Debtor's address, or attempt, offer or contract to do so, without the Secured Parties' prior written consent, except for those in the ordinary course of business.

(h) Limitations on Discounts, Compromises or Extensions. Other than in the ordinary course of business as generally conducted by the Debtor, the Debtor will not grant any extension of the time of payment of any item of Collateral, compromise, compound or settle the same for less than the full amount thereof, release, wholly or partially, any person or entity liable for the payment thereof, or allow any credit or discount whatsoever thereon.

(i) Maintenance of Insurance. The Debtor will maintain, with financially sound and reputable companies, insurance policies (i) insuring the Collateral against loss by fire, explosion, theft and such other casualties as may be reasonably satisfactory to the Agent and (ii) insuring the Debtor against liability for personal injury and property damage relating to such Collateral, such policies to be in such form and amounts and having such coverage, and naming the Secured Parties as additional named insureds, as may be reasonably satisfactory to the Agent. All such insurance shall (i) provide that no termination, cancellation, material reduction in

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amount or material change in coverage thereof shall be effective until at least thirty (30) days after receipt by the Agent of written notice thereof and (ii) be reasonably satisfactory in all other respects to the Agent. From time to time upon the request of the Agent, the Debtor shall deliver to the Agent insurance policies, certificates or binders as the Agent may from time to time reasonably request. In the event the Debtor, at any time or times hereafter, shall fail to obtain or maintain any of the policies of insurance required above, or to pay any premium in whole or in part relating hereto, then the Secured Parties, without waiving or releasing any obligation or any Default by the Debtor hereunder, may at any time or times thereafter (but shall be under no obligation to do so), obtain and maintain such policies of insurance and pay such premium and take any other action with respect thereto, which the Secured Parties deems advisable. All sums so disbursed by the Secured Parties, including reasonable attorneys' fees, court costs, expenses and other charges relating thereto, shall be payable on demand by the Debtor to the Secured Parties.

(j) Further Identification of Collateral. The Debtor will furnish to the Agent from time to time statements and schedules further identifying and describing the Collateral and such other reports in connection with the Collateral as the Agent may reasonably request, all in reasonable detail.

(k) Further Warranties. The Debtor further covenants, warrants and represents to the Secured Parties that all representations and warranties of the Debtor contained in this Security Agreement (whether appearing in this Section 4 or elsewhere) shall be true at the time of the Debtor's execution of this Security Agreement, shall survive the execution, delivery and acceptance thereof by the parties hereto and the closing of the transactions described herein or related hereto and shall be true during the duration thereof.

(l) Change of Name, Location. Debtor will give the Secured Parties at least ten (10) days' advance written notice of any change in its corporate name, state of incorporation or office address, or any other change of circumstances that would require a further filing or recording of any financing or continuation statement under the Uniform Commercial Code in any jurisdiction with respect to the security interests and liens created hereby.

5. Further Documentation; Pledge. At any time and from time to time, upon the written request of the Agent, and at the sole expense of the Debtor, the Debtor will promptly and duly execute and deliver such further instruments and documents and take such further action as the Agent may reasonably request for the purpose of obtaining or preserving the full benefits of this Security Agreement and of the rights and powers herein granted. The Debtor hereby authorizes the Agent to file or record any financing or continuation statements under the Uniform Commercial Code in effect in any jurisdiction with respect to the security interests and liens created hereby. A copy or other reproduction of this Security Agreement shall be sufficient as a financing statement for filing in any jurisdiction. If, at any time, any amount payable under or in connection with any of the Collateral shall be or become evidenced by any Instrument or Chattel Paper, the Debtor shall immediately deliver or cause the delivery to the Agent of such Instrument or Chattel Paper, duly endorsed in a manner satisfactory to the Agent, to be held as Collateral pursuant to this Security Agreement.

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6. Agent's Appointment as Attorney-in-Fact.

(a) Powers. The Debtor hereby irrevocably constitutes and appoints the Agent and any of its officers or agents with full power of substitution, as its true and lawful attorney-in-fact with full irrevocable power and authority in the place and stead of the Debtor and in the name of the Debtor or in its own name, from time to time in the Agent's discretion, for the purpose of carrying out the terms of this Security Agreement, to take any and all appropriate action and to execute any and all instruments which may be necessary or desirable to accomplish the purposes of this Security Agreement, and, without limiting the generality of the foregoing, the Debtor hereby gives the Agent the power and right, on behalf of the Debtor, without notice to or assent by the Debtor, to do the following:

(i) at any time when the authority of the Debtor to collect the item of Collateral has been curtailed or terminated pursuant to the first sentence of Section 3(c) hereof, or in the case of any Collateral, at any time when any Event of Default shall have occurred and is continuing, in the name of the Debtor or their own name, or otherwise, to take possession of and endorse and collect any checks, drafts, notes, acceptances or other instruments for the payment of moneys due under any item of Collateral or with respect to any other action or proceeding in any court of law or equity or otherwise deemed appropriate by the Agent for the purpose of collecting any and all such moneys due with respect to any Collateral whenever payable;

(ii) to pay or discharge taxes and liens levied or placed on or threatened against the Collateral, to effect any repairs or any insurance called for the terms of this Security Agreement and to pay all or any part of the premiums therefor and the costs thereof; and

(iii) upon the occurrence and during the continuance of any Event of Default, (A) to direct any party liable for any payment under any of the Collateral to make payment of any and all moneys due or to become due thereunder directly to the Agent or as the Agent shall direct; (B) to ask or demand for, collect, receive payment of and receipt for, any and all moneys, claims and other amounts due or to become due at any time in respect of or arising out of any Collateral; (C) to sign and endorse any invoices, freight or express bills, bills of lading, storage or warehouse receipts, drafts against Debtor, assignments, verifications, notices and other documents in connection with any of the Collateral; (D) to commence and prosecute any suits, actions or proceedings at law or in equity in any court of competent jurisdiction to collect the Collateral or any thereof and to enforce any other right in respect of any Collateral; (E) to defend any suit, action or proceeding brought against the Debtor with respect to any Collateral; (F) to settle, compromise or adjust any suit, action or proceeding described in clause (E) above and, in connection therewith, to give such discharges or releases as the Agent may deem appropriate; (G) to make any election with respect to the Collateral under Section 1111 of the U.S. Bankruptcy Code, or take any action under Section 364 or any other section of the U.S. Bankruptcy Code, now existing or as hereinafter

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amended; and (H) generally, to sell, transfer, pledge and make any agreement with respect to or otherwise deal with any of the Collateral as fully and completely as though the Agent were the absolute owner thereof for all purposes, and to do, at the Agent's option and the Debtor's expense, at any time, or from time to time, all acts and things which the Agent deems necessary to protect, preserve or realize upon the Collateral and the Agent's liens thereon and to effect the intent of this Security Agreement, all as fully and effectively as the Debtor might do.

At the reasonable request of the Agent, the Debtor shall deliver to the Agent, one or more further documents ratifying any and all actions that said attorneys shall lawfully take or do or cause to be taken or done by virtue hereof. This power of attorney is a power coupled with an interest and shall be irrevocable.

(b) Other Powers. The Debtor also authorizes the Agent, at any time and from time to time, to execute, in connection with the sales provided for in Section 9 hereof, any endorsements, assignments or other instruments of conveyance or transfer with respect to the Collateral.

(c) No Duty on Agent's Part. The powers conferred on the Agent hereunder are solely to protect the Secured Parties' interests in the Collateral and shall not impose any duty upon it to exercise any such powers. The Agent shall be accountable only for amounts that it actually receives as a result of the exercise of such powers, and neither it nor any of its shareholders, officers, directors, employees or agents shall be responsible or have any liability to any future holder of any interest in the Obligations, or to the Debtor or other pledgors or obligors for any act or failure to act hereunder, except for their own gross negligence or willful misconduct.

(d) Disputes. If a dispute arises between the Debtor and Secured Parties, the Agent may (but without obligation to do so) commence a civil action in a Court of competent jurisdiction and deposit the Collateral with the Court for determination as to the respective rights of Debtor and Secured Parties to receive the Collateral. In the event of litigation between the Debtor and Secured Parties concerning disbursement of the Collateral, the Agent may deposit the Collateral with the Court in which such litigation is pending. At any time, the Agent shall be entitled to apply to any Court of competent jurisdiction of the state and federal courts of New York County, New York to determine the rights of the parties hereto and in the event of such application may deposit the Collateral with such Court. In any event, the Agent shall be relieved and discharged from any liability or responsibility to the parties upon (i) delivering the Collateral to Debtor or Secured Parties in accordance with the terms of this Security Agreement or (ii) depositing the Collateral with a court in accordance with the terms of this Security Agreement.

(e) Stakeholder. The Agent is acting in the capacity of agent pursuant to this Security Agreement as a stakeholder only, without compensation and for the convenience and at the request of Secured Parties and Debtor. The duties of the Agent shall be determined solely by the express provisions of this Security Agreement and are purely ministerial in nature. As agent, the Agent shall have no duties or responsibilities (including, without limitation, any duty or

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responsibility to determine whether any delivery or payment is proper under any provision in this Security Agreement), except those duties and responsibilities expressly set forth in this Security Agreement. Moreover, nothing in this Agreement shall impose any duty upon the Agent to

exercise discretion. The Agent shall not be obligated to act except as expressly set forth in this Security Agreement or pursuant to a final non-appealable judgment, order, or decree of a Court of competent jurisdiction. If the Agent shall be uncertain as to its duties or rights as agent or shall receive instructions from any party with respect to this Security Agreement which, in its opinion, are in conflict with any of the provisions of this Security Agreement, the Agent shall be entitled to refrain from taking any action other than to keep safely the Collateral. The Agent may act or refrain from acting in respect of any matter referred to herein in full reliance upon and with the advice of counsel which may be selected by it and shall be fully protected in so acting or refraining from acting upon the advice of such counsel.

(f) Reliance. The Agent shall be entitled to rely for all purposes of this Security Agreement upon any notice, demand or other communication given to it pursuant to this Security Agreement, and each such notice, demand or communication shall be full authority to the Agent for any action taken, suffered, or omitted in reliance thereof. The Agent is not responsible or liable in any manner for the sufficiency, correctness, genuineness or validity of any writing delivered to it in accordance with this Security Agreement and may assume that any person signing such writing is authorized to do. The Agent shall have no duty to know or determine the performance or nonperformance of any provision of any agreement or arrangement that exists between Debtor and Secured Parties and/or any other third parties.

(g) Fees. The Agent shall be under no obligation to take any action with respect to the Collateral or pursuant to this Security Agreement which, in its reasonable opinion, shall be likely to involve it in any expense or liability, unless and until the Agent shall be furnished with an indemnity satisfactory to it against such expense and liability. The parties hereto shall jointly and severally indemnify, hold harmless, and defend the Agent from all loss, liability, expenses, costs, damages, litigation or sums (including, without limitation, reasonable attorneys' fees and disbursements) which the Agent may incur by acting pursuant to this Security Agreement, without prejudice to any right either party may have against the other to recover any amount paid pursuant to the foregoing. The indemnification obligation provided for in this Security Agreement shall be binding on the parties and on their respective successors and assigns.

7. Performance by Agent of Debtor's Obligations. If the Debtor fails to perform or comply with any of their agreements contained herein and the Agent, as provided for by the terms of this Security Agreement, shall itself perform or comply, or otherwise cause performance or compliance, with such agreement, the expenses of the Agent incurred in connection with such performance or compliance, together with interest thereon at a rate per annum equal to the Prime Rate (as published by the Wall Street Journal for the most recent applicable one-month period) plus 5%, shall be payable by the Debtor to the Agent on demand and shall constitute Obligations secured hereby.

8. Event of Default. An Event of Default hereunder shall exist upon the occurrence of an Event of Default under and as defined in any of the Related Notes (an "**Event of Default**").

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9. Remedies. If an Event of Default shall occur and be continuing, the Agent may exercise, in addition to all other rights and remedies granted to it in this Security Agreement and in any other instrument or agreement securing, evidencing or relating to the Obligations, all rights and remedies of a secured party under the Code. Without limiting the generality of the foregoing, the Agent, without demand of performance or other demand, presentment, protest, or notice of any kind (except any notice required by law referred to below) to or upon the Debtor or any other person or entity (all and each of which are hereby waived), may in such circumstances forthwith collect, receive, appropriate and realize upon the Collateral, or any part thereof, and/or may forthwith sell, lease, assign, give option or options to purchase, or otherwise dispose of and deliver the Collateral or any part thereof (or contract to do any of the foregoing), in one or more parcels at public or private sale or sales, at any exchange, broker's board or office of the Agent or elsewhere upon such terms and conditions as it may deem advisable and at such prices as it may deem best, for cash or on credit or for future delivery without assumption of any credit risk. The Agent shall have the right upon any such public sale or sales, and, to the extent permitted by law, upon any such private sale or sales, to purchase the whole or any part of the Collateral so sold, free of any right or equity or redemption in the Debtor, which right or equity is hereby waived or released. The Debtor further agrees, at the Agent's request, to assemble the Collateral and make it available to the Agent at places which the Agent shall reasonably select, whether at the Debtor's premises or elsewhere. The Agent shall apply the net proceeds of any such collection, recovery, receipt, appropriation, realization or sale, after deducting all reasonable costs and expenses of every kind incurred therein or incidental to the care or safekeeping of any of the Collateral or in any way relating to the Collateral or the rights of the Agent hereunder, including, without limitation, reasonable attorneys' fees and disbursements, to the payment in whole or in part of the Obligations, in such order as the Agent may elect, and only after such application and after the payment by the Agent of any other amount required by any provision of law, including, without limitation, Section 9-615 of the Code, need the Agent's account for the surplus, if any, to the Debtor. To the extent permitted by applicable law, the Debtor waives all claims, damages and demands they may acquire against the Agent arising out of the exercise by the Agent of any of its rights hereunder, provided that such release shall not apply to any claim, damage or demand resulting directly from the gross negligence or willful misconduct of the Agent. If any notice of a proposed sale or other disposition of Collateral shall be required by law, such notice shall be deemed reasonable and proper if given at least seven (7) days before such sale or other disposition. The Debtor shall remain liable for any deficiency if the proceeds of any sale or other disposition of the Collateral are insufficient to pay the Obligations and the fees and disbursements of any attorneys employed by the Agent to collect such deficiency.

10. Limitation on Duties Regarding Preservation of Collateral, etc The Agent's and each Secured Party's sole duty with respect to the custody, safekeeping and physical preservation of the Collateral in its possession, under Section 9-207 of the Code or otherwise, shall be to deal with it in the same manner as the Agent or such Secured Party deals with similar property for its own account. Neither the Agent, the Secured Parties nor any of their directors, officers, employees or agents shall be liable for failure to demand, collect or realize upon all or any part of the Collateral or for any delay in doing so or shall be under any obligation to sell or otherwise dispose of any Collateral upon the request of the Debtor or otherwise. None of the following

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shall affect the Obligations of the Debtor to the Secured Parties under this Security Agreement or the Secured Parties' rights with respect to the Collateral:

- (i) Acceptance or retention by the Secured Parties of other property or any interest in property as security for the Obligations;
- (ii) Release of all or any part of the Collateral;
- (iii) Release, extension, renewal, modification or compromise of the liability of any guarantor of the Obligations; or
- (iv) Failure of the Secured Parties to resort to other security or pursue the Debtor or any other obligor liable for any of the Obligations before resorting to the Collateral.

11. Powers Coupled with an Interest. All authorizations and agencies herein contained with respect to the Collateral are irrevocable and powers coupled with an interest.

12. Subordination. All Subordinated Debt shall be junior and subordinate and subject in right of payment to all Senior Debt of the Company, as hereinafter provided in this Section 12.

(a) Books of Account. The Company and the Subordinated Holder will mark their respective books of account to show that the Subordinated Debt is subordinated to Senior Debt in the manner and to the extent set forth in this Agreement.

(b) Payments on Account of Subordinated Debt, etc. Unless and until all Senior Debt shall have been indefeasibly paid in full, the Company will not make, and no Subordinated Holder will demand, accept or receive any direct or indirect payment (in cash, property, by set-off, as the proceeds of Collateral under this Agreement, or otherwise) of or on account of any Subordinated Debt and no such payment shall be due. Unless and until all Senior Debt shall have been indefeasibly paid in full, no Subordinated Holder will (i) commence any legal or judicial proceeding against the Company, or join with any creditor in bringing any such proceeding, under any bankruptcy, reorganization, readjustment of debt, arrangement of debt, receivership, liquidation or insolvency law or statute of the Federal or any state government unless the holder of 51% of the Senior Debt then outstanding shall join in such proceeding, or (ii) commence any action or proceeding against the Company to recover all or any part of such Subordinated Debt, or (iii) take any action to accelerate the maturity of any Subordinated Debt.

(c) Insolvency, etc. In the event of (i) any insolvency or bankruptcy proceeding, or any receivership, liquidation, reorganization or other similar proceeding in connection therewith, relative to the Company or its creditors or its property, or (ii) any proceeding for the voluntary liquidation, dissolution or other winding up of the Company, whether or not involving insolvency or bankruptcy, or (iii) any assignment for the benefit of creditors, or (iv) any distribution, division, marshalling or application of any of the properties or assets of the Company or the proceeds thereof, to creditors, voluntary or involuntary, whether or

not pursuant to the foreclosure or sale of Collateral pursuant to this Agreement or involving legal proceedings, then and in any such event:

A. all Senior Debt (including any interest thereon accruing after the commencement of any such proceedings) shall first be indefeasibly paid in full before any payment or distribution of any character, whether in cash, securities or other property, shall be made by the Company in respect of any Subordinated Debt;

B. all principal of, premium (if any) and interest on Subordinated Debt shall forthwith (notwithstanding the terms of subsection (b)) become due and payable, and any payment or distribution of any character, whether in cash, securities or other property, which would otherwise (but for the terms hereof) be payable or deliverable by the Company in respect of any Subordinated Debt (including any payment or distribution in respect of any Subordinated Debt by reason of any other indebtedness of the Company being subordinated to the Subordinated Debt, and any distribution of cash, property, stock or obligations which are issued pursuant to any order or decree of any court, or pursuant to reorganization, dissolution or liquidation proceedings, whether or not purporting to give effect to the subordination of the Subordinated Debt to the Senior Debt), shall be paid or delivered directly to the holders of Senior Debt at the time outstanding (or their respective representatives), ratably according to the respective aggregate amounts remaining unpaid thereon, until all Senior Debt shall have been indefeasibly paid in full, and each Subordinated Holder irrevocably authorizes, empowers and directs the Agent and all receivers, trustees, liquidators, conservators and others having authority in the premises to effect all such payments and deliveries;

C. each Subordinated Holder irrevocably authorizes and empowers (without imposing any obligation on) the Agent and each holder of Senior Debt at the time outstanding and such holder's representatives to demand, sue for, collect and receive such holder's ratable share of all such payments and distributions and to receipt therefor, and to file and prove all claims therefor and take all such other action (including the right to vote such Senior Debt holder's ratable share of the Subordinated Debt), in the name of the holders of the Subordinated Debt or otherwise, as such Senior Debt holder or such holder's representatives may determine to be necessary or appropriate for the enforcement of this Section 12; and

D. each Subordinated Holder shall execute and deliver to the Agent and each holder of Senior Debt and such

holder's representatives all such further instruments confirming the above authorization, and all such powers of attorney, proofs of claim, assignments of claim and other instruments, and shall take all such other action as may be reasonably requested by such holder or such holder's representatives, in order to enable such holder to enforce all claims upon or in respect of such holder's ratable share of the Subordinated Debt.

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(d) Payments and Distributions Received. If any payment or distribution of any character (whether in cash, securities or other property) or any security shall be received by any Subordinated Holder in contravention of any of the terms hereof and before all Senior Debt shall have been indefeasibly paid in full, such payment or distribution or security shall be held in trust for the benefit of, and shall be paid over or delivered and transferred to, the holders of the Senior Debt at the time outstanding (or their respective representatives) for application ratably to the payment of all Senior Debt remaining unpaid to the extent necessary to indefeasibly pay all such Senior Debt in full. In the event of the failure of any Subordinated Holder to endorse or assign any such payment, distribution or security, each holder of Senior Debt and each such holder's representative is hereby irrevocably authorized to endorse or assign the same.

(e) Excess Senior Debt Payment, Subrogation, etc. If cash, securities or other property otherwise payable or deliverable to the Subordinated Holders shall have been applied, pursuant to subsections 12(c) or 12(d) hereof, or by the Agent upon sale or foreclosure of the Collateral, to the indefeasible payment of Senior Debt in full, then and in such case, the holders of the Subordinated Debt (i) shall be entitled to receive from the holders of the Senior Debt at the time outstanding any payments or distributions received by such Senior Debt holders in excess of the amount sufficient to pay all Senior Debt in full and (ii) shall be subrogated to any rights of the holders of Senior Debt to receive all further payments or distributions applicable to the Senior Debt, until all principal of, premium (if any) and interest on the Subordinated Debt shall have been paid in full.

(f) No Security. So long as any of the Senior Debt shall not have been indefeasibly paid in full (i) the Company shall not give, and the Subordinated Holders shall not demand, accept or receive, any additional security, direct or indirect, for any Subordinated Debt (other than pursuant to the remaining sections of this Security Agreement), and (ii) neither the Company nor the Subordinated Holders will take or participate in any action to foreclose upon or otherwise receive any property in respect of any liens in favor of the Agent under this Agreement or any other loans now existing in favor of the Subordinated Holders with respect to the Subordinated Debt.

(g) Obligations Not Impaired. Except to the extent provided in this Agreement, Subordinated Debt may not become due and payable or be paid, provided that, nothing contained in this Agreement shall impair, as between the Company and any Subordinated Holder, the obligations of the Company to pay to such Subordinated Holder the principal thereof and the premium (if any) and interest thereon as and when the same shall become due and payable in accordance with the terms thereof, all subject to the rights of the holders of Senior Debt under this Section 12.

(h) Subordination Not Affected, etc. The terms of this Section 12, the subordination effected hereby and the rights of the holders of Senior Debt and the obligations of the Subordinated Holders and the Company hereunder shall not be affected by (i) any amendment of or addition or supplement to any Senior Debt or any instrument or agreement relating thereto (including, without limitation, any of the foregoing which would be effective to change the amount, manner, place or terms of payment or change or extend the time of payment

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of Senior Debt or to further restrict payments on Subordinated Debt); (ii) any exercise or non-exercise of any right, power or remedy under or in respect of any Senior Debt or any instrument or agreement relating thereto; (iii) any sale, exchange, release or other transaction affecting all or any part of any property at any time pledged or mortgaged to secure, or however securing, Senior Debt; (iv) any waiver, consent, release, indulgence, extension, renewal, modification, delay or other action, inaction or omission, in respect of any Senior Debt or any instrument or agreement relating thereto; or (v) any application by any holder or holders of Senior Debt of any amount or sum (by whomsoever paid or however realized) to Senior Debt, whether or not the holders of Subordinated Debt shall have had notice or knowledge of any of the foregoing.

(i) Changes, Waiver, etc. Neither any term of this Section 12, nor any term of any Subordinated Debt may be changed or waived except with the prior written consent of the holders of not less than 51% in aggregate principal amount of the Senior Debt at the time outstanding. This Section shall be a continuing agreement and shall remain in full force and effect so long as there are both Senior Debt and Subordinated Debt outstanding.

(j) Further Assurances, etc.

(i) Each Subordinated Holder and the Company authorizes the Agent or the Senior Lender to file any financing or continuation statement under the Uniform Commercial Code without the signature of such Subordinated Holder or the Company in order to evidence the security interest of the Senior Lender in the Subordinated Debt and the subordination of the Subordinated Debt as provided in this Agreement.

(ii) In order to carry out the terms and the intent of this Agreement more effectively, each Subordinated Holder and the Company each will do all acts and execute all further instruments necessary or convenient to preserve for the Senior Lender the benefit of this Agreement.

(k) Indefeasible Payment. For all purposes of this Agreement, Senior Debt shall not be deemed to have been indefeasibly paid in full unless (i) the holders thereof (or their duly authorized representatives) shall have received cash equal to the full amount of Senior Debt at the time outstanding and (ii) no petition shall have been filed under the Federal Bankruptcy Code in respect of the Company during the period next following such receipt which shall be equal to the applicable preference period specified in such Code (or any successor thereto).

(l) Legend. The Company and each Subordinated Holder, for itself and its successors and assigns as holder(s) of Subordinated Debt, covenant to cause each Note, agreement and instrument representing or evidencing any of the Subordinated Debt to have conspicuously affixed upon it a legend which shall read substantially as follows:

“This Note [instrument] [agreement] is subject to a Security and Subordination Agreement dated as of December 31, 2010 among Bio-Key International, Inc., The Shaar Fund, Ltd., Thomas Colatosti and The Shaar Fund, Ltd., as Agent for the benefit of The Shaar Fund, Ltd. and any other holders from time to time of the

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Senior Debt, as defined therein, pursuant to which Security and Subordination Agreement this Note [instrument] [agreement] has been subordinated to the Senior Debt. By its acceptance of this Note [instrument] [agreement], each holder hereof [each party hereto] agrees to be bound by the provisions of such Security and Subordination Agreement to the same extent as if originally named a Subordinated Holder under (and as defined in) such Security and Subordination Agreement.”

13. Severability. Any provision of this Security Agreement which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction.

14. Paragraph Headings. The paragraph and Section headings used in this Security Agreement are for convenience of reference only and are not to affect the construction hereof or be taken into consideration in the interpretation hereof.

15. No Waiver; Cumulative Remedies. The Agent shall not by any act (except by a written instrument pursuant to Section 16 hereof), delay, indulgence, omission or otherwise be deemed to have waived any right or remedy hereunder or to have acquiesced in any default or Event of Default or in any breach of any of the terms and conditions hereof. No failure to exercise, nor any delay in exercising, on the part of the Agent, any right, power or privilege hereunder shall operate as a waiver thereof. No single or partial exercise of any right, power or privilege hereunder shall preclude any other or further exercise thereof or the exercise of any other right, power or privilege. A waiver by the Agent of any right or remedy hereunder on any one occasion shall not be construed as a bar to any right or remedy that the Agent would otherwise have on any future occasion. The rights and remedies herein provided are cumulative, may be exercised singly or concurrently and are not exclusive of any rights or remedies provided by law.

16. Waivers and Amendments; Successors and Assigns. None of the terms or provisions of this Security Agreement may be waived, amended, supplemented or otherwise modified except by a written instrument executed by the Debtor and the Agent. This Security Agreement shall be binding upon the successors and assigns of the Debtor and shall inure to the benefit of the Agent and its successors and assigns.

17. Termination of Security Interest. This Security Agreement and the security interest in the Collateral created hereby shall automatically terminate upon the payment in full of all Obligations. In such event, the Agent agrees to execute appropriate releases of liens on the Collateral upon the request of the Debtor and at the Debtor's expense.

18. Governing Law. This Security Agreement shall be governed by and construed and interpreted in accordance with the laws of the State of New York without giving effect to applicable principles of conflict of law. Each of the parties submits to the exclusive jurisdiction of the state and federal courts of New York County, New York in connection with any dispute

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arising under this Security Agreement and hereby waives, to the maximum extent permitted by law, any objection, including any objection based on forum non-conveniens, to the bringing of any such proceeding in such jurisdictions.

19. Waiver of Trial by Jury. THE DEBTOR EXPRESSLY WAIVES ANY RIGHT TO TRIAL BY JURY OF ANY CLAIM, DEMAND, ACTION OR CAUSE OF ACTION (A) ARISING UNDER THIS SECURITY AGREEMENT OR ANY OTHER INSTRUMENT, DOCUMENT OR AGREEMENT EXECUTED OR DELIVERED IN CONNECTION HERewith, OR (B) IN ANY WAY CONNECTED WITH OR RELATED OR INCIDENTAL TO THE DEALINGS OF THE PARTIES HERETO OR ANY OF THEM WITH RESPECT TO THIS SECURITY AGREEMENT OR ANY OTHER INSTRUMENT, DOCUMENT OR AGREEMENT EXECUTED OR DELIVERED IN CONNECTION HERewith, OR THE TRANSACTIONS RELATED HERETO OR THERETO IN EACH CASE WHETHER NOW EXISTING OR HEREAFTER ARISING, AND WHETHER SOUNDING IN CONTRACT OR TORT OR OTHERWISE; AND THE DEBTOR HEREBY AGREES AND CONSENTS THAT ANY SUCH CLAIM, DEMAND, ACTION OR CAUSE OF ACTION SHALL BE DECIDED BY COURT TRIAL WITHOUT A JURY, AND THAT ANY PARTY MAY FILE AN ORIGINAL COUNTERPART OR A COPY OF THIS SECTION WITH ANY COURT AS WRITTEN EVIDENCE OF THIS WAIVER OF THE RIGHT TO TRIAL BY JURY.

20. Notices. All notices and other communications given or pursuant to this Note shall be in writing and shall be deemed effectively given upon the earlier of actual receipt or: (a) personal delivery to the party to be notified, (b) when sent, if sent by electronic mail or facsimile during normal business hours of the recipient, and if not sent during normal business hours, then on the recipient's next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) business day after deposit with a nationally recognized overnight courier, freight prepaid, specifying next business day delivery, with written verification of receipt. All communications shall be sent to the respective parties at the following addresses or to such other e-mail address, facsimile number or address as subsequently modified by written notice given in accordance with this Section 20:

If to the Debtor, to: BIO-key International, Inc.
3349 Highway 138
Building D, Suite B
Wall, NJ 07719
Attn: Chief Executive Officer
Facsimile: (732) 359-1101

with a copy (which shall not constitute notice) to: Choate, Hall & Stewart LLP
Two International Place
Boston, MA 02110
Attention: Charles J. Johnson, Esq.
Facsimile: (617) 248-4000

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If to the Agent or Shaar, to: The Shaar Fund Ltd.
c/o SS&C Fund Services N.V.
Pareraweg 45
Curacao, Netherlands Antilles
Facsimile: (599-9) 434-3560

with a copy (which shall not constitute notice) to: Meltzer, Lippe, Goldstein & Breitstone, LLP
190 Willis Avenue
Mineola, NY 11501
Attention: Ira R. Halperin, Esq.
Facsimile: (516) 747-0653

If to Colatosti, to: Thomas J. Colatosti
Chairman & CEO
American Security Ventures
P.O. Box 3
Lexington, MA 02420

21. Entire Agreement. This Security Agreement constitutes the full and entire understanding between the Debtor and the Secured Parties with respect to the subject matter hereof.

[Signature page follows]

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IN WITNESS WHEREOF, the parties have caused this Security Agreement to be duly executed and delivered as of the date first above written.

DEBTOR:

BIO-KEY INTERNATIONAL, INC.

By: _____

Name:

Title:

NOTEHOLDERS:

THE SHAAR FUND, LTD. (Senior Lender)

By: SS&C Fund Services N.V.

By:

Name:

Title:

Thomas J. Colatosti (Subordinated Lender)

[Signature Page to Security and Subordination Agreement]

AGENT:

THE SHAAR FUND, LTD.

By: SS&C Fund Services N.V.

By:

Name:

Title:

[Signature Page to Security and Subordination Agreement]

THIS WARRANT AND THE SHARES OF COMMON STOCK ISSUABLE UPON EXERCISE OF THIS WARRANT HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR ANY STATE SECURITIES LAWS. THIS WARRANT AND THE COMMON STOCK ISSUABLE UPON EXERCISE OF THIS WARRANT MAY NOT BE SOLD, OFFERED FOR SALE, PLEDGED OR HYPOTHECATED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT AS TO THIS WARRANT UNDER SAID ACT AND ANY APPLICABLE STATE SECURITIES LAWS OR AN OPINION OF COUNSEL REASONABLY SATISFACTORY TO BIO-KEY INTERNATIONAL, INC. THAT SUCH REGISTRATION IS NOT REQUIRED.

Right to Purchase up to 8,000,000 Shares of Common Stock of
BIO-key International, Inc.
(subject to adjustment as provided herein)

COMMON STOCK PURCHASE WARRANT

No. W-10-1

Issue Date: December 31, 2010

BIO-KEY INTERNATIONAL, INC., a corporation organized under the laws of the State of Delaware ("**BIO-key**"), hereby certifies that, for value received, THE SHAAR FUND, LTD., or assigns (the "**Holder**"), is entitled, subject to the terms set forth below, to purchase from the Company (as defined herein) from and after the Issue Date of this Warrant and at any time or from time to time before 5:00 p.m., New York time, through the close of business on the fifth anniversary of the date hereof (the "**Expiration Date**"), up to Eight Million (8,000,000) fully paid and nonassessable shares of Common Stock (as defined below) at the Exercise Price per share (as defined below). The number and character of such shares of Common Stock and the Exercise Price per share are subject to adjustment as provided herein.

As used herein the following terms, unless the context otherwise requires, have the following respective meanings:

- (a) The term "**Company**" shall include BIO-key and any corporation which shall succeed, or assume the obligations of, BIO-key hereunder.
- (b) The term "**Common Stock**" includes (i) the Company's common stock, par value \$0.0001 per share; and (ii) any other securities into which or for which any of the securities described in (a) may be converted or exchanged pursuant to a plan of recapitalization, reorganization, merger, sale of assets or otherwise.
- (c) The term "**Other Securities**" refers to any capital stock (other than Common Stock) and other securities of the Company or any other person (corporate or otherwise) which the holder of the Warrant at any time shall be entitled to receive, or shall have received, on the exercise of the Warrant, in lieu of or in addition to Common Stock, or which at any time shall be issuable or shall have been issued in exchange for or in replacement of Common Stock or Other Securities pursuant to Section 4 or otherwise.

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- (d) The term "**Exercise Price**" means \$0.30 per share, as adjusted from time to time as provided herein.

1. Exercise of Warrant

1.1 **Number of Shares Issuable upon Exercise** From and after the date hereof through and including the Expiration Date, the Holder shall be entitled to receive, upon exercise of this Warrant in whole or in part, by delivery of an original or fax copy of an exercise notice in the form attached hereto as Exhibit A (the "**Exercise Notice**"), shares of Common Stock of the Company, subject to adjustment pursuant to Section 4.

1.2 **Company Acknowledgment** The Company will, at the time of the exercise of the Warrant, upon the request of the holder hereof, acknowledge in writing its continuing obligation to afford to such holder any rights to which such holder shall continue to be entitled after such exercise in accordance with the provisions of this Warrant. If the holder shall fail to make any such request, such failure shall not affect the continuing obligation of the Company to afford to such holder any such rights.

1.3 **Trustee for Warrant Holders** In the event that a bank or trust company shall have been appointed as trustee for the holders of the Warrant pursuant to Subsection 3.2, such bank or trust company shall have all the powers and duties of a warrant agent (as hereinafter described) and shall accept, in its own name for the account of the Company or such successor person as may be entitled thereto, all amounts otherwise payable to the Company or such successor, as the case may be, on exercise of this Warrant pursuant to this Section 1.

2. Procedure for Exercise

2.1 **Delivery of Stock Certificates, Etc., on Exercise** The Company agrees that the shares of Common Stock purchased upon exercise of this Warrant shall be deemed to be issued to the Holder as the record owner of such shares as of the close of business on the date on which this Warrant shall have been surrendered and payment made for such shares in accordance herewith. As soon as practicable after the exercise of this Warrant in full or in part, and in any event within three (3) business days thereafter, the Company at its expense (including the payment by it of any applicable issue taxes) will cause to be issued in the name of and delivered to the Holder, or as such Holder (upon payment by such Holder of any applicable transfer taxes) may direct in compliance with applicable securities laws, a certificate or certificates for the

number of duly and validly issued, fully paid and non-assessable shares of Common Stock (or Other Securities) to which such Holder shall be entitled on such exercise, plus, in lieu of any fractional share to which such holder would otherwise be entitled, cash equal to such fraction multiplied by the then Fair Market Value (as defined below) of one full share, together with any other stock or other securities and property (including cash, where applicable) to which such Holder is entitled upon such exercise pursuant to Section 1 or otherwise. For purposes hereof, the "**Fair Market Value**" of a share of Common Stock as of a particular date (the "**Determination Date**") shall mean:

(a) If the Company's Common Stock is traded on the NYSE Amex Equities exchange or another national exchange or is quoted on the Global or Capital Market of The

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NASDAQ Stock Market, Inc. ("**Nasdaq**"), then the closing or last sale price, respectively, reported for the last business day immediately preceding the Determination Date.

(b) If the Company's Common Stock is not traded on the NYSE Amex Equities exchange or another national exchange or on the Nasdaq, but is traded on the FINRA OTC Bulletin Board, then the mean of the average of the closing bid and asked prices reported for the last business day immediately preceding the Determination Date.

(c) Except as provided in clause (d) below, if the Company's Common Stock is not publicly traded, then as the Holder and the Company agree or in the absence of agreement by arbitration in accordance with the rules then in effect of the American Arbitration Association, before a single arbitrator to be chosen from a panel of persons qualified by education and training to pass on the matter to be decided.

(d) If the Determination Date is the date of a liquidation, dissolution or winding up, or any event deemed to be a liquidation, dissolution or winding up pursuant to the Company's certificate of incorporation, then all amounts to be payable per share to holders of the Common Stock pursuant to the charter in the event of such liquidation, dissolution or winding up, plus all other amounts to be payable per share in respect of the Common Stock in liquidation under the charter, assuming for the purposes of this clause (d) that all of the shares of Common Stock then issuable upon exercise of the Warrant are outstanding at the Determination Date.

2.2 **Exercise.** Payment may be made either (i) in cash or by certified or official bank check payable to the order of the Company equal to the applicable aggregate Exercise Price, (ii) by delivery of the Warrant, or shares of Common Stock and/or Common Stock receivable upon exercise of the Warrant in accordance with the formula set forth below, (iii) by application of amounts due to the Holder under and in accordance with the terms of the Seven Percent (7%) Convertible Note dated the date hereof issued by the Company to the Holder (the "Note"), or (iv) by a combination of any of the foregoing methods, for the number of Common Shares specified in such Exercise Notice (as such exercise number shall be adjusted to reflect any adjustment in the total number of shares of Common Stock issuable to the Holder per the terms of this Warrant) and the Holder shall thereupon be entitled to receive the number of duly authorized, validly issued, fully-paid and non-assessable shares of Common Stock (or Other Securities) determined as provided herein. Notwithstanding any provisions herein to the contrary, if the Fair Market Value of one share of Common Stock is greater than the Exercise Price (at the date of calculation as set forth below), in lieu of exercising this Warrant for cash, the Holder may elect to receive shares equal to the value (as determined below) of this Warrant (or the portion thereof being exercised) by surrender of this Warrant at the principal office of the Company together with the properly endorsed Exercise Notice in which event the Company shall issue to the Holder a number of shares of Common Stock computed using the following formula:

$$X = Y \frac{(A-B)}{A}$$

Where X = the number of shares of Common Stock to be issued to the Holder

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Y = the number of shares of Common Stock purchasable under the Warrant or, if only a portion of the Warrant is being exercised, the portion of the Warrant being exercised (at the date of such calculation)

A = the Fair Market Value of one share of the Company's Common Stock (at the date of such calculation)

B = Exercise Price (as adjusted to the date of such calculation)

3. **Effect of Reorganization, Etc.**

3.1 **Reorganization, Consolidation, Merger, Etc.** In case at any time or from time to time, the Company shall (a) effect a reorganization, (b) consolidate with or merge into any other person, or (c) transfer all or substantially all of its properties or assets to any other person under any plan or arrangement contemplating the dissolution of the Company, then, in each such case, as a condition to the consummation of such a transaction, the Company shall have delivered to the Holder written notice thereof not less than 10 days' prior thereto and proper and adequate provision shall be made by the Company whereby the Holder of this Warrant, on the exercise hereof as provided in Section 1 at any time after the consummation of such reorganization, consolidation or merger or the effective date of such dissolution, as the case may be, shall receive, in lieu of the Common Stock (or Other Securities) issuable on such exercise prior to such consummation or such

effective date, the stock and other securities and property (including cash) to which such Holder would have been entitled upon such consummation or in connection with such dissolution, as the case may be, if such Holder had so exercised this Warrant, immediately prior thereto, all subject to further adjustment thereafter as provided in Section 4.

3.2 **Dissolution.** In the event of any dissolution of the Company following the transfer of all or substantially all of its properties or assets, the Company, concurrently with any distributions made to holders of its Common Stock, shall at its expense deliver or cause to be delivered to the Holder the stock and other securities and property (including cash, where applicable) receivable by the Holder of the Warrant pursuant to Section 3.1, or, if the Holder shall so instruct the Company, to a bank or trust company specified by the Holder and having its principal office in New York, NY as trustee for the Holder of the Warrant (the “Trustee”).

3.3 **Continuation of Terms.** Upon any reorganization, consolidation, merger or transfer (and any dissolution following any transfer) referred to in this Section 3, this Warrant shall continue in full force and effect and the terms hereof shall be applicable to the shares of stock and other securities and property receivable on the exercise of this Warrant after the consummation of such reorganization, consolidation or merger or the effective date of dissolution following any such transfer, as the case may be, and shall be binding upon the issuer of any such stock or other securities, including, in the case of any such transfer, the person acquiring all or substantially all of the properties or assets of the Company, whether or not such person shall have expressly assumed the terms of this Warrant as provided in Section 4. In the event this Warrant does not continue in full force and effect after the consummation of the transactions described in this Section 3, then the Company's securities and property (including

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cash, where applicable) receivable by the Holders of the Warrant will be delivered to Holder or the Trustee as contemplated by Section 3.2.

4. **Extraordinary Events Regarding Common Stock.** In the event that the Company shall (a) issue additional shares of the Common Stock as a dividend or other distribution on outstanding Common Stock, (b) subdivide its outstanding shares of Common Stock, or (c) combine its outstanding shares of the Common Stock into a smaller number of shares of the Common Stock, then, in each such event, the Exercise Price shall, simultaneously with the happening of such event, be adjusted by multiplying the then Exercise Price by a fraction, the numerator of which shall be the number of shares of Common Stock outstanding immediately prior to such event and the denominator of which shall be the number of shares of Common Stock outstanding immediately after such event, and the product so obtained shall thereafter be the Exercise Price then in effect. The Exercise Price, as so adjusted, shall be readjusted in the same manner upon the happening of any successive event or events described herein in this Section 4. The number of shares of Common Stock that the holder of this Warrant shall thereafter, on the exercise hereof as provided in Section 1, be entitled to receive shall be increased to a number determined by multiplying the number of shares of Common Stock that would otherwise (but for the provisions of this Section 4) be issuable on such exercise by a fraction of which (a) the numerator is the Exercise Price that would otherwise (but for the provisions of this Section 4) be in effect, and (b) the denominator is the Exercise Price in effect on the date of such exercise.

5. **Certificate as to Adjustments.** In each case of any adjustment or readjustment in the shares of Common Stock (or Other Securities) issuable on the exercise of the Warrant, the Company at its expense will promptly cause its Chief Financial Officer or other appropriate designee to compute such adjustment or readjustment in accordance with the terms of the Warrant and prepare a certificate setting forth such adjustment or readjustment and showing in detail the facts upon which such adjustment or readjustment is based, including a statement of (a) the consideration received or receivable by the Company for any additional shares of Common Stock (or Other Securities) issued or sold or deemed to have been issued or sold, (b) the number of shares of Common Stock (or Other Securities) outstanding or deemed to be outstanding, and (c) the Exercise Price and the number of shares of Common Stock to be received upon exercise of this Warrant, in effect immediately prior to such adjustment or readjustment and as adjusted or readjusted as provided in this Warrant. The Company will forthwith mail a copy of each such certificate to the holder of the Warrant and any Warrant agent of the Company (appointed pursuant to Section 11 hereof).

6. **Reservation of Stock Issuable on Exercise of Warrant** The Company will at all times reserve and keep available, solely for issuance and delivery on the exercise of the Warrant, shares of Common Stock (or Other Securities) from time to time issuable on the exercise of the Warrant.

7. **Investment Representations.** In connection with the Holder's acquisition of this Warrant, the Holder hereby represents and warrants to the Company as follows:

(a) The Holder is acquiring this Warrant for its own account for investment only, and not with a view to, or for sale in connection with, any distribution of this Warrant in

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violation of the Securities Act of 1933, as amended (the “Securities Act”), any rule or regulation under the Securities Act, or any state, foreign or other securities laws.

(b) The Holder acknowledges that an investment in this Warrant involves a high degree of risk.

(c) The Holder is able to protect its own interest in the transactions contemplated hereby, can bear the economic risk of this investment (including possible complete loss of such investment) for an indefinite period of time and has such knowledge and experience in

financial or business matters such that he is capable of evaluating the merits and risks of the investment in this Warrant.

(d) The Holder understands that this Warrant has not been registered under the Securities Act or under the securities laws of any jurisdiction, by reason of reliance upon certain exemptions, and that the reliance of the Company on such exemptions is predicated upon the accuracy of the representations and warranties contained herein.

(e) The Holder has had the opportunity to ask questions of and receive answers from representatives of the Company and to obtain additional information, documents and records relating to the Company, its business and the investment contemplated hereby.

(f) The Holder understands that this Warrant is characterized as a "restricted security" under the federal securities laws inasmuch as it has been acquired in a transaction not involving a public offering and that under such laws and applicable regulations (and under other applicable securities laws) such Securities may not be transferred or resold without registration under the Securities Act or other applicable laws or pursuant to a valid exemption from registration under the Securities Act and such laws. The Holder understands that the Company requires an opinion of counsel satisfactory to the Company that registration is not required as a condition to any transfer where this Warrant is not being registered.

(g) The Holder understands that the Company will be under no obligation to register this Warrant under the Securities Act (or any other applicable securities laws).

(h) The Holder is familiar with Securities and Exchange Commission Rule 144 and understands the resale limitations imposed thereby and by the Securities Act; and

(i) The Holder is an "Accredited Investor" pursuant to Rule 501 of Regulation D under the Securities Act.

8. **Assignment; Exchange of Warrant.** Subject to compliance with applicable securities laws, this Warrant, and the rights evidenced hereby, may be transferred by any registered holder hereof (a "Transferor") in whole or in part. On the surrender for exchange of this Warrant, with the Transferor's endorsement in the form of Exhibit B attached hereto (the "Transferor Endorsement Form") and together with evidence reasonably satisfactory to the Company demonstrating compliance with applicable securities laws, which shall include, without limitation, the provision of a legal opinion from the Transferor's counsel (at the Company's expense) that such transfer is exempt from the registration requirements of applicable securities laws, and with payment by the Transferor of any applicable transfer taxes) will issue and deliver

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to or on the order of the Transferor thereof a new Warrant of like tenor, in the name of the Transferor and/or the transferee(s) specified in such Transferor Endorsement Form (each a "Transferee"), calling in the aggregate on the face or faces thereof for the number of shares of Common Stock called for on the face or faces of the Warrant so surrendered by the Transferor.

9. **Replacement of Warrant.** On receipt of evidence reasonably satisfactory to the Company of the loss, theft, destruction or mutilation of this Warrant and, in the case of any such loss, theft or destruction of this Warrant, on delivery of an indemnity agreement or security reasonably satisfactory in form and amount to the Company or, in the case of any such mutilation, on surrender and cancellation of this Warrant, the Company at its expense will execute and deliver, in lieu thereof, a new Warrant of like tenor.

10. **Maximum Exercise.** In no event shall the Holder be entitled to exercise this Warrant with respect to any shares of Common Stock or shall the Company have the obligation to issue any such shares to the extent that, after such exercise and issuance, the Holder would be deemed to be the beneficial owner of more than 4.99% of the outstanding shares of Common Stock. For purposes of this Section, beneficial ownership shall be determined in accordance with Section 13(d) of the Securities Exchange Act of 1934, as amended. Notwithstanding the foregoing, the restriction described in this Section 10 may be revoked upon 75 days prior notice from the Holder to the Company or immediately upon notice upon an Event of Default under the Convertible Note.

11. **Warrant Agent.** The Company may, by written notice to the each Holder of the Warrant, appoint an agent for the purpose of issuing Common Stock (or Other Securities) on the exercise of this Warrant pursuant to Section 1, exchanging this Warrant pursuant to Section 8, and replacing this Warrant pursuant to Section 9, or any of the foregoing, and thereafter any such issuance, exchange or replacement, as the case may be, shall be made at such office by such agent.

12. **Transfer on the Company's Books.** Until this Warrant is transferred on the books of the Company, the Company may treat the registered holder hereof as the absolute owner hereof for all purposes, notwithstanding any notice to the contrary.

13. **Notices, Etc.** All notices and other communications from the Company to the Holder of this Warrant shall be mailed by first class registered or certified mail, postage prepaid, at such address as may have been furnished to the Company in writing by such Holder or, until any such Holder furnishes to the Company an address, then to, and at the address of, the last Holder of this Warrant who has so furnished an address to the Company.

14. **Governing Law.** THIS WARRANT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE ALWS OF THE STATE OF NEW YORK, WITHOUT REGARD TO PRINCIPLES OF CONFLICTS OF LAWS. ANY ACTION BROUGHT BY ANY PARTY AGAINST ANOTHER CONCERNING THE TRANSACTIONS CONTEMPLATED BY THIS WARRANT SHALL BE BROUGHT ONLY IN THE STATE COURTS OF NEW YORK OR IN THE FEDERAL COURTS LOCATED IN THE STATE OF NEW YORK IN EACH CASE SITTING IN THE CITY OF NEW YORK, BOROUGH OF MANHATTAN. ALL PARTIES AND THE INDIVIDUALS EXECUTING THIS WARRANT

ON BEHALF OF THE COMPANY AGREE TO SUBMIT TO THE JURISDICTION OF SUCH COURTS AND WAIVE TRIAL BY JURY. IN THE EVENT THAT ANY PROVISION OF THIS WARRANT DELIVERED IN CONNECTION HERewith IS INVALID OR UNENFORCEABLE UNDER ANY APPLICABLE STATUTE OR RULE OF LAW, THEN SUCH PROVISION SHALL BE DEEMED INOPERATIVE TO THE EXTENT THAT IT MAY CONFLICT THEREWITH AND SHALL BE DEEMED MODIFIED TO CONFORM WITH SUCH STATUTE OR RULE OF LAW. ANY SUCH PROVISION WHICH MAY PROVE INVALID OR UNENFORCEABLE UNDER ANY LAW SHALL NOT AFFECT THE VALIDITY OR ENFORCEABILITY OF ANY OTHER PROVISION OF THIS WARRANT.

15. **Miscellaneous.** This Warrant and any term hereof may be changed, waived, discharged or terminated only by an instrument in writing signed by the party against which enforcement of such change, waiver, discharge or termination is sought. The prevailing party shall be entitled to recover from the other party its reasonable attorney's fees and costs. The headings in this Warrant are for purposes of reference only, and shall not limit or otherwise affect any of the terms hereof. The invalidity or unenforceability of any provision hereof shall in no way affect the validity or enforceability of any other provision hereof. The Company acknowledges that legal counsel participated in the preparation of this Warrant and, therefore, stipulates that the rule of construction that ambiguities are to be resolved against the drafting party shall not be applied in the interpretation of this Warrant to favor any party against the other party.

IN WITNESS WHEREOF, each of the undersigned has executed this Warrant as of the date first written above.

BIO-KEY INTERNATIONAL, INC.

By: _____
Name: _____
Title: _____

Acknowledged and agreed:

THE SHAAR FUND, LTD.

By: SS&C Fund Services N.V.

By: _____
Name: _____
Title: _____

EXHIBIT A

FORM OF SUBSCRIPTION

(To Be Signed Only On Exercise Of Warrant)

TO: BIO-key International, Inc.

Attention: Chief Financial Officer

The undersigned, pursuant to the provisions set forth in the attached Warrant (No.), hereby irrevocably elects to purchase (check applicable box):

- _____ shares of the Common Stock covered by such Warrant; or
- _____ the maximum number of shares of Common Stock covered by such Warrant pursuant to the cashless exercise procedure set forth in Section 2.

The undersigned herewith makes payment of the full Exercise Price for such shares at the price per share provided for in such Warrant, which is \$. Such payment takes the form of (check applicable box or boxes):

- \$ _____ in lawful money of the United States; and/or

- the cancellation of such portion of the attached Warrant as is exercisable for a total of _____ shares of Common Stock (using a Fair Market Value of \$ _____ per share for purposes of this calculation); and/or
- the cancellation of such number of shares of Common Stock as is necessary, in accordance with the formula set forth in Section 2.2, to exercise this Warrant with respect to the maximum number of shares of Common Stock purchasable pursuant to the cashless exercise procedure set forth in Section 2; and/or
- the application of \$ _____ in respect of the annual installment of principal or accrued interest owing under the Convertible Note.

The undersigned requests that the certificates for such shares be issued in the name of, and delivered to _____ whose address is _____

The undersigned represents and warrants that all offers and sales by the undersigned of the securities issuable upon exercise of the within Warrant shall be made pursuant to registration of the Common Stock under the Securities Act of 1933, as amended (the "**Securities Act**") or pursuant to an exemption from registration under the Securities Act.

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Dated: _____

(Signature must conform to name of holder as specified on the face of the Warrant)

Address: _____

EXHIBIT B

FORM OF TRANSFEROR ENDORSEMENT

(To Be Signed Only On Transfer Of Warrant)

For value received, the undersigned hereby sells, assigns, and transfers unto the person(s) named below under the heading "**Transferees**" the right represented by the within Warrant to purchase the percentage and number of shares of Common Stock of BIO-key International, Inc. into which the within Warrant relates specified under the headings "Percentage Transferred" and "**Number Transferred**," respectively, opposite the name(s) of such person(s) and appoints each such person Attorney to transfer its respective right on the books of BIO-key International, Inc. with full power of substitution in the premises.

Transferees	Address	Percentage Transferred	Number Transferred

Dated: _____

(Signature must conform to name of holder as specified on the face of the Warrant)

Address: _____

SIGNED IN THE PRESENCE OF:

(Name)

ACCEPTED AND AGREED:
[TRANSFEREE]

(Name)

THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR APPLICABLE STATE SECURITIES LAWS (COLLECTIVELY, THE "LAWS"). THE NOTE HAS BEEN ACQUIRED FOR INVESTMENT AND MAY NOT BE OFFERED FOR SALE, SOLD, TRANSFERRED OR ASSIGNED IN THE ABSENCE OF EITHER (I) AN EFFECTIVE REGISTRATION STATEMENT FOR THE NOTE UNDER THE LAWS, OR (II) AN OPINION OF COUNSEL PROVIDED TO THE ISSUER IN FORM, SUBSTANCE AND SCOPE REASONABLY ACCEPTABLE TO THE ISSUER TO THE EFFECT THAT REGISTRATION IS NOT REQUIRED UNDER THE LAWS DUE TO AN AVAILABLE EXCEPTION TO OR EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE LAWS.

DATE: December 31, 2010

U.S. \$3,157,759

BIO-KEY INTERNATIONAL, INC.

SEVEN PERCENT (7%) SECURED PROMISSORY NOTE

FOR VALUE RECEIVED, BIO-KEY INTERNATIONAL, INC., a corporation duly organized and validly existing under the laws of the State of Delaware, U.S.A. (the "Company"), promises to pay to the order of THE SHAAR FUND, LTD., the registered holder hereof and its successors and assigns (the "Holder"), Three Million One Hundred Fifty Seven Thousand Seven Hundred Fifty Nine Dollars (\$3,157,759) in five (5) installments, as follows: (1) Three Hundred Thousand Dollars (\$300,000) on April 30, 2011, (2) Three Hundred Thousand Dollars (\$300,000) on July 31, 2011, (3) Three Hundred Thousand Dollars (\$300,000) on October 31, 2011, (4) One Million Four Hundred Thousand Dollars (\$1,400,000) on December 31, 2011, and (5) Eight Hundred Fifty Seven Thousand Seven Hundred Fifty Nine Dollars (\$857,759) on December 31, 2012 (the "Final Maturity Date"), together with interest from the date hereof on the principal sum from time to time outstanding at the rate provided for below.

The outstanding principal amount of this Seven Percent (7%) Secured Promissory Note (this "Note") shall bear interest at a rate per annum equal to seven percent (7%). Interest shall be (a) calculated on the basis of a 360 day year and (b) payable on each principal repayment installment date specified above, in arrears, commencing on April 30, 2011 until the Final Maturity Date. Accrual of interest on the outstanding principal amount, payable in cash, shall commence on the date hereof and shall continue until payment in full of the outstanding principal amount of this Note has been made or duly provided for. The interest so payable will be paid to the person in whose name this Note (or one or more predecessor Notes) is registered on the records of the Company regarding registration of the Note (the "Note Register").

The principal of, and interest on, this Note are payable in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts, at the address last appearing on the Note Register of the Company as designated in writing by the Holder hereof from time to time. The Company will pay the outstanding principal of and any

and all accrued and unpaid interest due upon this Note on the Final Maturity Date to the record Holder of this Note as of the fifth (5) business day prior to the Final Maturity Date and addressed to such Holder at the last address appearing on the Note Register.

This Note is subject to the following additional provisions:

1. Note Exchangeable. The Note is exchangeable at any time for an equal aggregate principal amount of Notes of different authorized denominations, as requested by the Holder surrendering the same without the Company's written consent. No service charge will be made for such registration or transfer or exchange.

2. Withholding. The Company shall be entitled to withhold from all payments of principal or interest pursuant to this Note any amounts required to be withheld under the applicable provisions of the United States income tax or other applicable laws at the time of such payments.

3. Transfer/Exchange of Note; Legend.

(a) This Note has been issued subject to investment representations of the original purchaser hereof and may be transferred or exchanged only in compliance with the Securities Act of 1933, as amended (the "1933 Act") and applicable state securities laws. Prior to due presentment for transfer of this Note, the Company and any agent of the Company may treat the person in whose name this Note is duly registered on the Company's Note Register as the owner hereof for the purpose of receiving payment as herein provided and for all other purposes, whether or not his Note be overdue, and neither the Company nor any such agent shall be affected or bound by notice to the contrary. If presentment for transfer is made, the parties agree hereunder to execute any and all documents necessary to effectuate said transfer within thirty (30) days of presentment.

(b) The Holder understands and acknowledges by its acceptance hereof that (i) except as provided herein, this Note has not been and is not being registered under the 1933 Act or any state securities laws, and may not be offered for sale, sold, assigned or transferred unless (A) subsequently registered thereunder, or (B) pursuant to an exemption from such registration; (ii) any sale of such securities made in reliance on Rule 144 promulgated under the 1933 Act may be made only in accordance with the terms of said Rule and further, if said Rule is not applicable, any resale of such securities under circumstances in which the seller (or the person through whom the sale is made) may be deemed to be an underwriter (as that term is defined in the 1933 Act) may require compliance with some other regulation and/or exemption

under the 1933 Act or the rules and regulations of the United States Securities and Exchange Commission (the “SEC”) thereunder; and (iii) neither the Company nor any other person is under any obligation, other than as provided herein to register such securities under the 1933 Act or any state securities laws or to comply with the terms and conditions of any exemption thereunder.

4. Prepayment by the Company. The Company shall have the right (but not the obligation), upon at least ten (10) days’ prior written notice to the Holder, to prepay all or any portion of this Note, in whole or in part, without premium or penalty, provided the Company is not then in violation of any of its obligations under this Note.

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5. Default. If one or more of the following described “Events of Default” shall occur:

(a) The Company shall fail to perform or observe, in any material respect, any covenant, term, provision, condition, agreement or obligation of the Company under this Note and such failure shall continue uncured for a period of seven (7) days after written notice from the Holder of such failure; or

(b) The Company shall either: (i) become insolvent; (ii) admit in writing its inability to pay its debts generally or as they become due; (iii) make an assignment for the benefit of creditors or commence proceedings for its dissolution; or (iv) apply for, or consent to the appointment of, a trustee, liquidator, or receiver for its or for a substantial part of its property or business; or

(c) A Change of Control shall occur; or

(d) A trustee, liquidator or receiver shall be appointed for the Company or for a substantial part of its property or business without the Company’s consent and such appointment is not discharged within sixty (60) days after such appointment; or

(e) Any governmental agency or any court of competent jurisdiction at the instance of any governmental agency shall assume custody or control of the whole or any substantial portion of the properties or assets of the Company and shall not be dismissed within sixty (60) days thereafter; or

(f) After the date of this Note, any money judgment, writ or note of attachment, or similar process in excess of One Hundred Thousand Dollars (\$100,000.00) in the aggregate shall be entered or filed against the Company or any of its properties or assets and shall remain unpaid, unvacated, unbonded or unstayed for a period of fifteen (15) days or in any event later than five (5) days prior to the date of any proposed sale thereunder; or

(g) The Company shall default in the payment of any other outstanding indebtedness incurred or guaranteed by the Company beyond any period of notice and opportunity to cure, or the payment of such indebtedness shall be accelerated by the holder thereof; or

(h) Bankruptcy, reorganization, insolvency or liquidation proceedings or other proceedings for relief under any bankruptcy law or any law for the relief of debtors shall be instituted by or against the Company and, if instituted against the Company, shall not be dismissed within sixty days after such institution or the Company shall by any action or answer approve of, consent to, or acquiesce in any such proceedings or admit the material allegations of, or default in answering a petition filed in, any such proceeding;

then, or at any time thereafter, and in any and every such case, unless such Event of Default shall have been waived in writing by the Holder (which waiver in one instance shall not be deemed to be a waiver in another instance or for any other prior or subsequent Event of Default) at the option of the Holder and in the Holder’s sole discretion, the Holder may immediately accelerate the maturity hereof, whereupon all principal and interest hereunder shall be immediately due and

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payable, without presentment, demand, protest or notice of any kind, all of which are hereby expressly waived by the Company, anything herein or other instrument contained to the contrary notwithstanding, and the Holder may immediately, and upon the expiration of any period of grace, enforce any and all of the Holder’s rights and remedies provided herein or any other rights or remedies afforded by law or equity. In addition, if this Note is not paid when due, the Company shall pay interest on overdue principal and (to the fullest extent permitted by applicable law) on overdue interest at the rate of twelve (12%) percent per annum.

As used herein, “Change of Control” means (i) any merger, consolidation, share exchange, business combination, issuance of securities, acquisition of securities, tender offer, exchange offer or other similar transaction (A) in which the Company is a constituent corporation, (B) in which a person, firm or other entity (“Person”) or “group” (as defined in the Securities Exchange Act of 1934, as amended, and the rules promulgated thereunder) of Persons directly or indirectly acquires beneficial or record ownership of securities representing more than 50% of the outstanding voting securities of the Company, or (C) in which the Company issues securities representing more than 50% of the outstanding securities of any class of voting securities of the Company or (ii) any sale, lease, exchange, transfer, license, acquisition or disposition of any assets that constitute more than 50% of the assets of the Company on a consolidated basis.

6. Maximum Payments. Nothing contained herein shall be deemed to establish or require the payment of a rate of interest or other

charges in excess of the maximum permitted by applicable law. In the event that the rate of interest required to be paid or other charges hereunder exceed the maximum permitted by such law, any payments in excess of such maximum shall be credited against amounts owed by the Company to the Holder and thus refunded to the Company.

7. Obligations of the Company herein are Unconditional No provision of this Note shall alter or impair the obligation of the Company, which obligation is absolute and unconditional, to repay the principal amount of this Note at the time, place, rate, and in the coin or currency hereinabove stated. This Note and all other Notes now or hereafter issued in replacement of this Note on the same or similar terms are direct obligations of the Company. This Note ranks at least equally with all other Notes now or hereafter issued under the terms set forth herein.

8. Note Holder Not Deemed a Stockholder No Holder, as such, of this Note shall be entitled to vote or receive dividends or be deemed the holder of shares of the Company for any purpose, nor shall anything contained in this Note be construed to confer upon the Holder hereof, as such, any of the rights of a stockholder of the Company or any right to vote, give or withhold consent to any corporate action (whether any reorganization, issue of stock, reclassification of stock, consolidation, merger, conveyance or otherwise), receive notice of meetings, receive dividends or subscription rights, or otherwise.

9. Restrictive Covenant Until the principal amount of this Note and all accrued and unpaid interest thereon is paid in full as provided herein, the Company will not issue any loan or debt secured by any assets of the Company, except pursuant to the Security Agreement, as defined below.

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10. Security The obligations represented by this Note are secured by Collateral (as defined in the Security Agreement) pursuant to a Security and Subordination Agreement dated as of the date hereof by and among the Company, the Noteholders, as defined therein, and The Shaar Fund, Ltd., as collateral agent for the Noteholders, in substantially the form attached as Exhibit A hereto (the "Security Agreement"). This Note is senior in right of payment to the Seven Percent (7%) Secured Promissory Note of even date herewith issued in favor of Thomas Colatosti, pursuant to the terms, provisions and conditions of the subordination set forth in the Security Agreement.

11. No Limitation on Corporate Action No provisions of this Note and no right or option granted or conferred hereunder shall in any way limit, affect or abridge the exercise by the Company of any of its corporate rights or powers to recapitalize, amend its Certificate of Incorporation, reorganize, consolidate or merge with or into another corporation, or to transfer all or any part of its property or assets, or the exercise of any other of its corporate rights and powers.

12. Waiver of Demand, Presentment, Etc. The Company hereby expressly waives demand and presentment for payment, notice of nonpayment, protest, notice of protest, notice of dishonor, notice of acceleration or intent to accelerate, bringing of suit and diligence in taking any action to collect amounts called for hereunder and shall be directly and primarily liable for the payment of all sums owing and to be owing hereunder, regardless of and without any notice, diligence, act or omission as or with respect to the collection of any amount called for hereunder.

13. Failure or Delay Not Waiver No failure or delay on the part of the Holder in the exercise of any power, right or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any such power, right or privilege preclude other or further exercise thereof or of any other right, power or privilege. All rights and remedies existing hereunder are cumulative to, and not exclusive of, any rights or remedies otherwise available.

14. Attorney's Fees The Company agrees to pay all costs and expenses, including without limitation reasonable attorney's fees, which may be incurred by the Holder in collecting any amount due under this Note or in enforcing any of Holder's conversion rights as described herein.

15. Access to Books and Records The Holder will have the right to inspect and audit the Company's original books, records, and documents at any time and from time to time, during normal business hours, upon reasonable notice to the Company.

16. Enforceability In case any provision of this Note is held by a court of competent jurisdiction to be excessive in scope or otherwise invalid or unenforceable, such provision shall be adjusted rather than voided, if possible, so that it is enforceable to the maximum extent possible, and the validity and enforceability of the remaining provisions of this Note will not in any way be affected or impaired thereby.

17. Governing Law This Note shall be governed by and construed in accordance with the laws of the state of New York without giving effect to applicable principles of conflict of law. Each of the parties submits to the exclusive jurisdiction of the state and federal courts of New York County, New York in connection with any dispute arising under this Note and hereby

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waives, to the maximum extent permitted by law, any objection, including any objection based on forum non conveniens, to the bringing of any such proceeding in such jurisdictions. To the extent determined by such court, the Company shall reimburse the Holder for any reasonable legal fees and disbursements incurred by the Holder in enforcement of or protection of any of its rights under this Note.

18. Assignment This Note shall not be assigned by the Company without the prior written consent of the Holder. This Note shall bind the Company and its successors and permitted assigns and shall inure to the benefit of the Holder and its successors and assigns.

By:

Name:

Title:

[Signature Page to Shaar Secured Promissory Note]

Exhibit A

Form of Security Agreement

See attached.

THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR APPLICABLE STATE SECURITIES LAWS (COLLECTIVELY, THE "LAWS"). THE NOTE HAS BEEN ACQUIRED FOR INVESTMENT AND MAY NOT BE OFFERED FOR SALE, SOLD, TRANSFERRED OR ASSIGNED IN THE ABSENCE OF EITHER (I) AN EFFECTIVE REGISTRATION STATEMENT FOR THE NOTE UNDER THE LAWS, OR (II) AN OPINION OF COUNSEL PROVIDED TO THE ISSUER IN FORM, SUBSTANCE AND SCOPE REASONABLY ACCEPTABLE TO THE ISSUER TO THE EFFECT THAT REGISTRATION IS NOT REQUIRED UNDER THE LAWS DUE TO AN AVAILABLE EXCEPTION TO OR EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE LAWS.

THIS NOTE IS SUBJECT TO A SECURITY AND SUBORDINATION AGREEMENT DATED AS OF DECEMBER 31, 2010 AMONG BIO-KEY INTERNATIONAL, INC., THE SHAAR FUND, LTD., THOMAS COLATOSTI AND THE SHAAR FUND, LTD., AS AGENT FOR THE BENEFIT OF THE SHAAR FUND, LTD. AND ANY OTHER HOLDERS FROM TIME TO TIME OF THE SENIOR DEBT, AS DEFINED THEREIN, PURSUANT TO WHICH SECURITY AND SUBORDINATION AGREEMENT THIS NOTE HAS BEEN SUBORDINATED TO THE SENIOR DEBT. BY ITS ACCEPTANCE OF THIS NOTE, THE HOLDER HEREOF AGREES TO BE BOUND BY THE PROVISIONS OF SUCH SECURITY AND SUBORDINATION AGREEMENT TO THE SAME EXTENT AS IF ORIGINALLY NAMED A SUBORDINATED HOLDER UNDER (AND AS DEFINED IN) SUCH SECURITY AND SUBORDINATION AGREEMENT.

DATE: December 31, 2010

U.S. \$350,804

BIO-KEY INTERNATIONAL, INC.

SEVEN PERCENT (7%) SECURED PROMISSORY NOTE

FOR VALUE RECEIVED, BIO-KEY INTERNATIONAL, INC., a corporation duly organized and validly existing under the laws of the State of Delaware, U.S.A. (the "Company"), promises to pay to the order of THOMAS J. COLATOSTI, the registered holder hereof and his successors and assigns (the "Holder"), Three Hundred Fifty Thousand Eight Hundred Four Dollars (\$350,804) on December 31, 2012 (the "Final Maturity Date"), together with interest from the date hereof on the principal sum from time to time outstanding at the rate provided for below.

The outstanding principal amount of this Seven Percent (7%) Secured Promissory Note (this "Note") shall bear interest at a rate per annum equal to seven percent (7%). Interest shall be (a) calculated on the basis of a 360 day year and (b) payable, in arrears, on the Final Maturity Date. Accrual of interest on the outstanding principal amount, payable in cash, shall commence on the date hereof and shall continue until payment in full of the outstanding principal amount of this Note has been made or duly provided for. The interest so payable will be paid to the person in

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whose name this Note (or one or more predecessor Notes) is registered on the records of the Company regarding registration of the Note (the "Note Register").

The principal of, and interest on, this Note are payable in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts, at the address last appearing on the Note Register of the Company as designated in writing by the Holder hereof from time to time. The Company will pay the outstanding principal of and any and all accrued and unpaid interest due upon this Note on the Final Maturity Date to the record Holder of this Note as of the fifth (5th) business day prior to the Final Maturity Date and addressed to such Holder at the last address appearing on the Note Register.

This Note is subject to the following additional provisions:

1. Note Exchangeable. The Note is exchangeable at any time for an equal aggregate principal amount of Notes of different authorized denominations, as requested by the Holder surrendering the same without the Company's written consent. No service charge will be made for such registration or transfer or exchange.

2. Withholding. The Company shall be entitled to withhold from all payments of principal or interest pursuant to this Note any amounts required to be withheld under the applicable provisions of the United States income tax or other applicable laws at the time of such payments.

3. Transfer/Exchange of Note; Legend.

(a) This Note has been issued subject to investment representations of the original purchaser hereof and may be transferred or exchanged only in compliance with the Securities Act of 1933, as amended (the "1933 Act") and applicable state securities laws. Prior to due presentment for transfer of this Note, the Company and any agent of the Company may treat the person in whose name this Note is duly registered on the Company's Note Register as the owner hereof for the purpose of receiving payment as herein provided and for all other purposes, whether or not his Note be overdue, and neither the Company nor any such agent shall be affected or bound by notice to the contrary. If presentment for transfer is made, the parties agree hereunder to execute any and all documents necessary to effectuate said transfer within thirty (30) days of presentment.

(b) The Holder understands and acknowledges by its acceptance hereof that (i) except as provided herein, this Note has

not been and is not being registered under the 1933 Act or any state securities laws, and may not be offered for sale, sold, assigned or transferred unless (A) subsequently registered thereunder, or (B) pursuant to an exemption from such registration; (ii) any sale of such securities made in reliance on Rule 144 promulgated under the 1933 Act may be made only in accordance with the terms of said Rule and further, if said Rule is not applicable, any resale of such securities under circumstances in which the seller (or the person through whom the sale is made) may be deemed to be an underwriter (as that term is defined in the 1933 Act) may require compliance with some other regulation and/or exemption under the 1933 Act or the rules and regulations of the United States Securities and Exchange Commission (the "SEC") thereunder; and (iii) neither the Company nor any other person is under any obligation, other than as provided

herein to register such securities under the 1933 Act or any state securities laws or to comply with the terms and conditions of any exemption thereunder.

4. Prepayment by the Company. The Company shall have the right (but not the obligation), upon at least ten (10) days' prior written notice to the Holder, to prepay all or any portion of this Note, in whole or in part, without premium or penalty, provided the Company is not then in violation of any of its obligations under this Note.

5. Default. If one or more of the following described "Events of Default" shall occur:

(a) The Company shall fail to perform or observe, in any material respect, any covenant, term, provision, condition, agreement or obligation of the Company under this Note and such failure shall continue uncured for a period of seven (7) days after written notice from the Holder of such failure; or

(b) The Company shall either: (i) become insolvent; (ii) admit in writing its inability to pay its debts generally or as they become due; (iii) make an assignment for the benefit of creditors or commence proceedings for its dissolution; or (iv) apply for, or consent to the appointment of, a trustee, liquidator, or receiver for its or for a substantial part of its property or business; or

(c) A Change of Control shall occur; or

(d) A trustee, liquidator or receiver shall be appointed for the Company or for a substantial part of its property or business without the Company's consent and such appointment is not discharged within sixty (60) days after such appointment; or

(e) Any governmental agency or any court of competent jurisdiction at the instance of any governmental agency shall assume custody or control of the whole or any substantial portion of the properties or assets of the Company and shall not be dismissed within sixty (60) days thereafter; or

(f) After the date of this Note, any money judgment, writ or note of attachment, or similar process in excess of One Hundred Thousand Dollars (\$100,000.00) in the aggregate shall be entered or filed against the Company or any of its properties or assets and shall remain unpaid, unvacated, unbonded or unstayed for a period of fifteen (15) days or in any event later than five (5) days prior to the date of any proposed sale thereunder; or

(g) The Company shall default in the payment of any other outstanding indebtedness incurred or guaranteed by the Company beyond any period of notice and opportunity to cure, or the payment of such indebtedness shall be accelerated by the holder thereof; or

(h) Bankruptcy, reorganization, insolvency or liquidation proceedings or other proceedings for relief under any bankruptcy law or any law for the relief of debtors shall be instituted by or against the Company and, if instituted against the Company, shall not be dismissed within sixty days after such institution or the Company shall by any action or answer approve of,

consent to, or acquiesce in any such proceedings or admit the material allegations of, or default in answering a petition filed in, any such proceeding;

then, or at any time thereafter, and in any and every such case, unless such Event of Default shall have been waived in writing by the Holder (which waiver in one instance shall not be deemed to be a waiver in another instance or for any other prior or subsequent Event of Default) at the option of the Holder and in the Holder's sole discretion, the Holder may immediately accelerate the maturity hereof, whereupon all principal and interest hereunder shall be immediately due and payable, without presentment, demand, protest or notice of any kind, all of which are hereby expressly waived by the Company, anything herein or other instrument contained to the contrary notwithstanding, and the Holder may immediately, and upon the expiration of any period of grace, enforce any and all of the Holder's rights and remedies provided herein or any other rights or remedies afforded by law or equity. In addition, if this Note is not paid when due, the Company shall pay interest on overdue principal and (to the fullest extent permitted by applicable law) on overdue interest at the rate of twelve (12%) percent per annum.

As used herein, "Change of Control" means (i) any merger, consolidation, share exchange, business combination, issuance of securities, acquisition of securities, tender offer, exchange offer or other similar transaction (A) in which the Company is a constituent corporation, (B) in

which a person, firm or other entity (“Person”) or “group” (as defined in the Securities Exchange Act of 1934, as amended, and the rules promulgated thereunder) of Persons directly or indirectly acquires beneficial or record ownership of securities representing more than 50% of the outstanding voting securities of the Company, or (C) in which the Company issues securities representing more than 50% of the outstanding securities of any class of voting securities of the Company or (ii) any sale, lease, exchange, transfer, license, acquisition or disposition of any assets that constitute more than 50% of the assets of the Company on a consolidated basis.

6. Maximum Payments. Nothing contained herein shall be deemed to establish or require the payment of a rate of interest or other charges in excess of the maximum permitted by applicable law. In the event that the rate of interest required to be paid or other charges hereunder exceed the maximum permitted by such law, any payments in excess of such maximum shall be credited against amounts owed by the Company to the Holder and thus refunded to the Company.

7. Obligations of the Company herein are Unconditional. No provision of this Note shall alter or impair the obligation of the Company, which obligation is absolute and unconditional, to repay the principal amount of this Note at the time, place, rate, and in the coin or currency hereinabove stated. This Note and all other Notes now or hereafter issued in replacement of this Note on the same or similar terms are direct obligations of the Company. This Note ranks at least equally with all other Notes now or hereafter issued under the terms set forth herein.

8. Note Holder Not Deemed a Stockholder. No Holder, as such, of this Note shall be entitled to vote or receive dividends or be deemed the holder of shares of the Company for any purpose, nor shall anything contained in this Note be construed to confer upon the Holder hereof, as such, any of the rights of a stockholder of the Company or any right to vote, give or withhold consent to any corporate action (whether any reorganization, issue of stock, reclassification of

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stock, consolidation, merger, conveyance or otherwise), receive notice of meetings, receive dividends or subscription rights, or otherwise.

9. Restrictive Covenant. Until the principal amount of this Note and all accrued and unpaid interest thereon is paid in full as provided herein, the Company will not issue any loan or debt secured by any assets of the Company, except pursuant to the Security Agreement, as defined below.

10. Security. The obligations represented by this Note are secured by Collateral (as defined in the Security Agreement) pursuant to a Security and Subordination Agreement dated as of the date hereof by and among the Company, the Noteholders, as defined therein, and The Shaar Fund, Ltd., as collateral agent for the Noteholders, in substantially the form attached as **Exhibit A** hereto (the “Security Agreement”). This Note is subordinated in right of payment to the Seven Percent (7%) Secured Promissory Note of even date herewith issued in favor of The Shaar Fund, Ltd., pursuant to the terms, provisions and conditions of the subordination set forth in the Security Agreement.

11. No Limitation on Corporate Action. No provisions of this Note and no right or option granted or conferred hereunder shall in any way limit, affect or abridge the exercise by the Company of any of its corporate rights or powers to recapitalize, amend its Certificate of Incorporation, reorganize, consolidate or merge with or into another corporation, or to transfer all or any part of its property or assets, or the exercise of any other of its corporate rights and powers.

12. Waiver of Demand, Presentment, Etc. The Company hereby expressly waives demand and presentment for payment, notice of nonpayment, protest, notice of protest, notice of dishonor, notice of acceleration or intent to accelerate, bringing of suit and diligence in taking any action to collect amounts called for hereunder and shall be directly and primarily liable for the payment of all sums owing and to be owing hereunder, regardless of and without any notice, diligence, act or omission as or with respect to the collection of any amount called for hereunder.

13. Failure or Delay Not Waiver. No failure or delay on the part of the Holder in the exercise of any power, right or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any such power, right or privilege preclude other or further exercise thereof or of any other right, power or privilege. All rights and remedies existing hereunder are cumulative to, and not exclusive of, any rights or remedies otherwise available.

14. Attorney's Fees. The Company agrees to pay all costs and expenses, including without limitation reasonable attorney's fees, which may be incurred by the Holder in collecting any amount due under this Note or in enforcing any of Holder's conversion rights as described herein.

15. Access to Books and Records. The Holder will have the right to inspect and audit the Company's original books, records, and documents at any time and from time to time, during normal business hours, upon reasonable notice to the Company.

16. Enforceability. In case any provision of this Note is held by a court of competent jurisdiction to be excessive in scope or otherwise invalid or unenforceable, such provision shall be

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adjusted rather than voided, if possible, so that it is enforceable to the maximum extent possible, and the validity and enforceability of the remaining provisions of this Note will not in any way be affected or impaired thereby.

17. Governing Law. This Note shall be governed by and construed in accordance with the laws of the state of New York without giving effect to applicable principles of conflict of law. Each of the parties submits to the exclusive jurisdiction of the state and federal courts of New York County, New York in connection with any dispute arising under this Note and hereby waives, to the maximum extent permitted by law, any objection, including any objection based on forum non conveniens, to the bringing of any such proceeding in such jurisdictions. To the extent determined by such court, the Company shall reimburse the Holder for any reasonable legal fees and disbursements incurred by the Holder in enforcement of or protection of any of its rights under this Note.

18. Assignment. This Note shall not be assigned by the Company without the prior written consent of the Holder. This Note shall bind the Company and its successors and permitted assigns and shall inure to the benefit of the Holder and its successors and assigns.

19. Amendment Provision. Neither this Note nor any term hereof may be amended, waived, discharged or terminated other than by a written instrument signed by the Company and the Holder.

20. Entire Agreement. This Note and constitutes the full and entire understanding between the Company and the Holder with respect to the subject matter hereof and thereof.

21. Notices. All notices and other communications given or made pursuant to this Note shall be in writing and shall be deemed effectively given upon the earlier of actual receipt or: (a) personal delivery to the party to be notified, (b) when sent, if sent by electronic mail or facsimile during normal business hours of the recipient, and if not sent during normal business hours, then on the recipient's next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) business day after deposit with a nationally recognized overnight courier, freight prepaid, specifying next business day delivery, with written verification of receipt. All communications shall be sent to the respective parties at the following addresses or to such other e-mail address, facsimile number or address as subsequently modified by written notice given in accordance with this Section 19:

If to the Borrower, to:	BIO-key International, Inc. 3349 Highway 138 Building D, Suite B Wall, NJ 07719 Attn: Chief Executive Officer Facsimile: (732) 359-1101
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with a copy (which shall not constitute notice) to:	Choate, Hall & Stewart LLP Two International Place Boston, MA 02110 Attention: Charles J. Johnson, Esq. Facsimile: (617) 248-4000
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If to the Holder, to:	Thomas J. Colatosti Chairman & CEO American Security Ventures P.O. Box 3 Lexington, MA 02420
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22. Waiver of Jury Trial. THE COMPANY EXPRESSLY WAIVES ANY RIGHT TO TRIAL BY JURY OF ANY CLAIM, DEMAND, ACTION OR CAUSE OF ACTION (A) ARISING UNDER THIS NOTE OR ANY OTHER INSTRUMENT, DOCUMENT OR AGREEMENT EXECUTED OR DELIVERED IN CONNECTION HERewith, OR (B) IN ANY WAY CONNECTED WITH OR RELATED OR INCIDENTAL TO THE DEALINGS OF THE PARTIES HERETO OR ANY OF THEM WITH RESPECT TO THIS NOTE OR ANY OTHER INSTRUMENT, DOCUMENT OR AGREEMENT EXECUTED OR DELIVERED IN CONNECTION HERewith, OR THE TRANSACTIONS RELATED HERETO OR THERETO IN EACH CASE WHETHER NOW EXISTING OR HEREAFTER ARISING, AND WHETHER SOUNDING IN CONTRACT OR TORT OR OTHERWISE; AND THE BORROWER HEREBY AGREES AND CONSENTS THAT ANY SUCH CLAIM, DEMAND, ACTION OR CAUSE OF ACTION SHALL BE DECIDED BY COURT TRIAL WITHOUT A JURY, AND THAT ANY PARTY MAY FILE AN ORIGINAL COUNTERPART OR A COPY OF THIS SECTION WITH ANY COURT AS WRITTEN EVIDENCE OF THIS WAIVER OF THE RIGHT TO TRIAL BY JURY.

[No further text on this page]

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IN WITNESS WHEREOF, the Company has caused this instrument to be duly executed by an officer thereunto duly authorized, all as of the date first hereinabove written.

By: _____
Name:
Title:

[Signature Page to Colatosti Secured Promissory Note]

Exhibit A

Form of Security Agreement

See attached.

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference into the registration statement of BIO-key International, Inc., on Form S-8 (file no. 333-137414), of our report dated March 23, 2011 relating to the financial statements which appear in this Form 10-K for the year ended December 31, 2010.

/s/ / Rotenberg Meril Solomon Bertiger & Guttilla, P.C.
ROTENBERG MERIL SOLOMON BERTIGER & GUTTILLA, P.C.
Saddle Brook, New Jersey
March 23, 2011

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference into the registration statement of BIO-key International, Inc., on Form S-8 (file no. 333-137414), of our report dated March 26, 2010 relating to the financial statements which appear in this Form 10-K for the year ended December 31, 2009.

/s/ CCR LLP

Westborough, Massachusetts
March 23, 2011

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Michael W. DePasquale, certify that:

1. I have reviewed this annual report on Form 10-K of BIO-key International, Inc. (the "Company");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Company and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting;
5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: March 23, 2011

/s/ MICHAEL W. DEPASQUALE

Michael W. DePasquale
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Cecilia Welch, certify that:

1. I have reviewed this annual report on Form 10-K of BIO-key International, Inc. (the "Company");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Company and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting;
5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: March 23, 2011

/s/ CECILIA WELCH

Cecilia Welch
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of BIO-key International, Inc. (the "Company") on Form 10-K for the period ended December 31, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael W. DePasquale, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

BIO-KEY INTERNATIONAL, INC.

By: /s/ MICHAEL W. DEPASQUALE

Michael W. DePasquale

Chief Executive Officer

Date: March 23, 2011

