

BIO KEY INTERNATIONAL INC
Form SB-2
April 30, 2004

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As filed with the Securities and Exchange Commission on April 30, 2004

Registration No. 333-

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM SB-2

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

BIO-key International, Inc.

(Exact name of registrant as specified in its charter)

Minnesota
(State of incorporation)

3577
*(Primary Standard Industrial
Classification Code Number)*

41-1741861
*(I.R.S. Employer
Identification No.)*

1285 Corporate Center Drive, Suite 175, Eagan, MN 55121, (651) 687-0414

(Address and telephone number of registrant's principal executive offices)

Michael W. DePasquale

Chief Executive Officer

BIO-key International, Inc., 1285 Corporate Center Drive, Suite 175, Eagan, MN 55121, (651) 687-0414

(Name, address and telephone number of agent for service)

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Approximate date of commencement of proposed sale to public: From time to time after this registration statement becomes effective.

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If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, as amended, or the Securities Act, check the following box.

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

Calculation of Registration Fee

Title of each class of securities to be registered	Number of units to be registered(1)	Proposed maximum aggregate offering price per unit(2)	Proposed maximum aggregate offering price(2)	Amount of registration fee
Common Stock, \$.01 par value per share	2,422,108 shares(3)	\$1.95	\$4,723,111	\$598
Common Stock, \$.01 par value per share	8,888,928 shares(4)	\$1.95	\$17,333,410	\$2,196
Common Stock, \$.01 par value per share, issuable upon exercise of warrants	4,444,464 shares(5)	\$1.95	\$8,666,705	\$1,098

- (1) Pursuant to Rule 416 under the Securities Act, this registration statement also covers an indeterminate number of additional shares of the registrant's common stock as may be issuable upon any stock split, stock dividend or similar transaction.
- (2) Estimated pursuant to Rule 457(c) under the Securities Act solely for the purpose of calculating the registration fee, based upon the average of the high and low sale prices of the registrant's common stock as reported on the OTC Bulletin Board on April 28, 2004.
- (3) Shares of the registrant's common stock issued in connection with an agreement and plan of merger dated as of March 30, 2004.
- (4) Shares of the registrant's common stock issued pursuant to a securities purchase agreement dated as of March 31, 2004.
- (5) Shares of the registrant's common stock issuable upon the exercise of warrants issued pursuant to a securities purchase agreement dated as of March 31, 2004.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. These securities may not be sold until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Subject to completion, dated April 30, 2004

PROSPECTUS

15,755,500 Shares

BIO-key International, Inc.

Common Stock

We are registering up to 15,755,500 shares of our common stock for offer or sale by the selling security holders named in this prospectus. Of the shares being registered, 11,311,036 shares have been issued to the selling security holders and 4,444,464 shares are issuable upon exercise of warrants issued to the selling security holders. Of the 11,311,036 shares that have been issued to the selling security holders, 2,416,108 shares are being held in escrow and may not be offered or sold by the selling security holders until such escrow is released. The selling security holders may offer or sell all or a portion of their shares publicly or through private transactions at prevailing market prices or at negotiated prices. We will not receive any proceeds from the shares being registered for offer and sale by the selling security holders.

**Investing in our common stock involves a high degree of risk.
See "Risk Factors" beginning on page 3.**

Our common stock is traded on the OTC Bulletin Board under the symbol "BKYI". The last reported sale price of our common stock on April 29, 2004 was \$1.74 per share.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

, 2004

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You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information that is different. This prospectus may only be used where it is legal to sell these securities. The information in this prospectus may only be accurate on the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of our common stock. Applicable rules of the Securities and Exchange Commission may require us to update this prospectus in the future.

PROSPECTUS SUMMARY

About BIO-key International, Inc.

BIO-key International, Inc., formerly known as SAC Technologies, Inc. (the "Company," "BIO-key," "we" or "us"), is in the business of developing and marketing biometric technologies. Biometrics is the science of analyzing specific human characteristics which are unique to an individual in order to identify a specific individual from a broader population. We develop and market fingerprint identification software technology. Our technology identifies a specific person based on the unique characteristics of his or her fingerprint. Our technology scans a person's fingerprint and identifies that person within seconds without using a password, key card, personal identification number or any other identifying data. Fingerprint analysis is an accurate and reliable method to distinguish one individual from another and is generally viewed as less intrusive than many other biometric identification methods. We believe our fingerprint identification software technology will have a broad range of applications relating to information, identity, network, access and personal security including:

Securing Internet sites and electronic transactions;

Prevention of identity and data theft;

Securing access to logical networks and applications; and

Securing access to buildings and restricted areas.

Fingerprint identification technologies require the use of an optical reader to scan a person's finger. Rather than distributing integrated products, we license our technology. To execute this plan, we have designed our core software to integrate with virtually any finger reading or scanning device. We actively market and sell our technology to biometric system integrators and value added resellers focused on the security and logical access markets. A number of our customers have begun to deploy our technology on a run-time basis which is generating recurring quarterly revenues. Our current business plan is to:

License our core technology "VST" to original equipment manufacturers, systems integrators and application developers to develop and market products and applications which can then be sold to end users;

License WEB-key , our web-based biometric authentication solution; and

Provide for "device independent" finger identification matching for virtually any application utilizing the latest advances in scanning technology.

Our technology provides a reliable and secure user identification/authentication system for public and private computer networks. WEB-key is designed to secure access to proprietary information residing on remote servers which is transmitted via the Internet. It is compatible with Oracle server software and new security features in Microsoft's Internet Explorer Versions 5.5 SP2 and 6.0. Network authentication is typically accomplished by using passwords. Since passwords can be lost, transferred, stolen or forgotten, we believe our WEB-key biometric solution is a more secure method for verifying the identity of remote users and eliminates the substantial administrative costs associated with tracking and reissuing new passwords.

In addition to our core technologies, we recently acquired Public Safety Group, Inc. ("PSG"), a privately held leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology is a software solution that provides police officers and other security personnel instantaneous access to criminal, civil and private database information in a wireless environment. PocketCop© is a handheld application that allows law enforcement officers to access state and federal databases over the wireless network for PalmOS, Windows CE and PocketPC. With the use of a portable wireless handheld device and PocketCop© application software, an authorized user can access

suspect information such as wanted status, warrant status, vehicle registration and driver license status. With our acquisition of PSG, we believe there is a substantial market opportunity to integrate our VST and WEB-key biometric technologies with the PSG mobile solution.

Although biometric based solutions currently compete with more traditional security methods such as keys, cards, personal identification numbers and security personnel, biometric technology is becoming an acceptable approach to physical and logical security. We have evolved from a development stage company to a revenue generating company, but we have sustained substantial losses to date. We completed a private placement equity offering in March 2004 that resulted in approximately \$12,000,000 in gross proceeds to the Company, and management believes that we now have sufficient funds to meet our working capital requirements for at least the next twenty-four (24) months. To the extent that we will require additional capital to support our operations, expand our marketing and sales efforts and to execute our business plan, we may need to obtain additional financing.

Our principal executive offices are located at 1285 Corporate Center Drive, Suite 175, Eagan, Minnesota 55121 and our telephone number is (651) 687-0414.

About the Offering

This prospectus covers the public sale of up to 15,755,500 shares of our common stock to be sold by the selling security holders identified herein. Of this amount, 2,422,108 shares were issued to certain of the selling security holders in connection with our acquisition on March 30, 2004 of PSG, a privately-held company providing wireless solutions for law enforcement and public safety markets. This acquisition was accomplished through the exchange of such shares of our common stock, in addition to cash and our assumption of certain indebtedness of PSG, for all of the outstanding capital stock of PSG. Following the acquisition, PSG became a wholly-owned subsidiary of the Company.

8,888,928 shares of our common stock covered by this prospectus were issued on March 31, 2004 in a private placement transaction to certain institutional and accredited investors pursuant to a securities purchase agreement by and among the Company and such investors. The remaining 4,444,464 shares of our common stock covered by this prospectus are issuable upon the exercise of warrants issued to the investors pursuant to such securities purchase agreement. The aggregate purchase price paid by the investors for the securities issued in such private placement was approximately \$12,000,000.

RISK FACTORS

An investment in our common stock involves a high degree of risk. You should carefully consider the following information about certain of the risks of investing in our common stock, together with other information contained in this prospectus, before you decide to purchase our common stock.

Business and Financial Risks

Since our formation, we have generated minimal revenue and have sustained substantial operating losses. We expect to continue to have negative cash flow for the immediate future which will require us to raise additional capital to continue operations.

We were formed in 1993 and have yet to generate any significant revenue. From inception through December 31, 2003, we have accumulated a deficit of approximately \$27,676,000 and negative cash flow from operations of approximately \$19,038,000. As of December 31, 2003, we had positive working capital of approximately \$1,085,000, but a stockholders' deficit of approximately \$9,136,000. Since our inception, we have focused almost exclusively on developing our core technology and have not generated any significant revenue. In order to generate revenue, we have developed a direct sales force and anticipate the need to retain additional sales, marketing and technical support personnel and incur substantial expenses. We can not assure you that we will be able to secure these necessary resources, that a significant market for our technology will develop or that we will be able to achieve our targeted revenue. For these reasons, we anticipate that our negative cash flow from operations will continue.

Our 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 generated any 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:

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 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 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 solution provides 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 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 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 customers. Any such default 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 technology is 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 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 developed a limited distribution channel and may not have the resources or ability to sustain these efforts or generate any meaningful sales.

In order to generate revenue, 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; and

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 cannot 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.

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 is widely adopted, it would significantly reduce the potential market for our fingerprint identification technology.

We depend on our chairman of the board and chief executive officer and need additional marketing and technical personnel to successfully market our technology. 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. We have an employment contract with Michael W. DePasquale, our Chief Executive Officer. 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. We continue to retain additional 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 limited intellectual property protection for our core technology provides a meaningful 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. More recently, we filed a patent application with respect to our VST (Vector Segment Technology), the core algorithm of our biometric identification solution. We cannot assure you that any patents will be issued, or that, if issued, 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, particularly as the number of products and competitors in the biometric industry segment grows.

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 any significant revenue and have experienced substantial losses, including approximately \$3,826,000 during 2003. We also have a stockholders' deficit as of December 31, 2003. In March 2004, we completed a private placement equity offering that resulted in approximately \$12,000,000 in gross proceeds to the Company, and management now believes that we have sufficient funds to meet our working capital requirements for at least the next twenty-four (24) months. To the extent that we will require additional capital to support our operations, expand our marketing and sales efforts and to execute our business plan to substantially increase revenue, we may need to obtain additional financing through the issuance of debt or equity securities. We have not and 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 or generate such revenues, we may not be able to execute our business plan or continue operations.

We may not be able to successfully integrate Public Safety Group, Inc. into our operations.

On March 30, 2004, we acquired all of the outstanding capital stock of Public Safety Group, Inc. ("PSG"), a privately-held provider of wireless solutions for law enforcement and public safety markets based in Winter Park, Florida. The integration of PSG into our operations involves a number of risks, including:

difficulty integrating PSG's operations and personnel;

diversion of management attention;

potential disruption of ongoing business;

inability to retain key personnel;

inability to successfully incorporate PSG's products and services into our product and service offerings and to develop new products and services; and

impairment of relationships with employees, customers or vendors.

Failure to overcome these risks or any other problems encountered in connection with the acquisition of PSG could slow our growth or lower the quality of our services, which could reduce customer demand. The result could be an adverse effect on our financial results.

Risks Related To Our Common Stock

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

As of April 28, 2004, 26,336,336 shares of our common stock were reserved for issuance upon exercise or conversion of the following securities:

14,891,195 shares upon exercise of outstanding stock options and warrants;

804,208 shares upon exercise of options available for future grant under our existing option plans; and

10,690,933 shares or more upon conversion of our outstanding shares of series C convertible preferred stock.

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.

A substantial number of our convertible securities are convertible into shares of common stock at a conversion price of \$.75 per share. Most of these shares are eligible for public resale. The trading price of our common stock and our ability to raise additional financing may be adversely effected by the influx into the market of such a substantial number of shares.

Our outstanding convertible preferred stock is convertible into 10,690,933 shares of common stock at a per share conversion price of \$.75 which is substantially less than the current trading price of our shares. Although many of the shares issuable upon conversion of our convertible preferred stock are eligible for public resale under Securities and Exchange Commission Rule 144, we have agreed to file a registration statement to cover the public resale of all of these shares. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares and substantially dilute the ownership interests of our existing shareholders. In the event that our stock trades below \$.75 per share, in order to raise additional financing we would likely be required to issue additional shares of common stock or securities convertible into common stock at a purchase or conversion price, as applicable, of less than \$.75 per share. Any issuance of shares at a purchase price of less than \$.75 per share would reduce the conversion price of our series C preferred shares to such lower price. This would require us to issue additional shares upon conversion of our series C preferred shares and further dilute the ownership interests of our existing shareholders. To the extent these factors are viewed negatively by the market, it may provide an incentive for persons to execute short sales of our common stock that could adversely affect the trading price of our common stock.

Applicable Securities and Exchange Commission 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. Because our common stock continues to trade below \$5.00 per share, our common stock is considered a "penny stock" and is subject to Securities and Exchange Commission 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. In addition, the terms of our outstanding series C preferred shares preclude us from declaring or paying a dividend on our common stock unless a dividend is also declared or paid, as applicable, on our series C preferred shares. 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 prospectus 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 fifteen (15) registered broker dealers currently make a market in our common stock, we cannot 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.

Minnesota anti-takeover law and certain provisions of our articles of incorporation may discourage attempts to effect a change in control of our company, which may adversely affect the value of our common stock.

We are governed by the provisions of Section 302A.673 of the Minnesota Business Corporation Act ("MBCA"). In general, the law prohibits a public Minnesota corporation from engaging in a "business combination" (with an "interested shareholder") for a period of four years after the date of the transaction in which the person became an interested shareholder, unless the business combination is approved in a prescribed manner. A "business combination" includes mergers, share exchanges, asset sales, plan or proposal of liquidation or dissolution, recapitalization, issuance and transfers of shares in excess of five percent (5%) or more of the Company's shares. An "interested shareholder" means any person who owns directly or indirectly ten percent (10%) or more of a public corporation's outstanding voting stock or an affiliate or associate of a public corporation which owns, or within four years did own, ten percent (10%) or more of the public corporation's outstanding voting stock. These provisions regarding certain business combinations under the MBCA could have the effect of delaying, deferring,

or preventing a change in control of the company or the removal of existing management. We have no control over, and therefore cannot predict, what effect these impediments to the ability of third parties to acquire control of us might have on the market price of our common stock. In addition, we are authorized to issue 5,000,000 shares of preferred stock which may be issued by our Board of Directors on such terms and with such rights, preferences and designations as the Board may determine. Depending upon the rights, preferences and designations assigned to it, issuance of shares of preferred stock could delay, deter or prevent a change in control of our company to the detriment of our shareholders.

FORWARD LOOKING STATEMENTS

This prospectus contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. All statements other than statements of historical facts contained in this prospectus, 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 that our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure that they will be achieved. Actual results may differ materially due to a number of factors. Many of these factors are set forth in the "RISK FACTORS" section of this prospectus. Actual results may differ materially from the forward-looking statements contained in this prospectus. 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.

USE OF PROCEEDS

The shares are being registered hereunder for resale by the selling security holders. We will not receive any proceeds from the sale of the shares by the selling security holders. We will receive the exercise price of certain warrants held by certain of the selling security holders. We expect to use the proceeds of any such sales for general working capital purposes.

MARKET FOR OUR COMMON STOCK AND RELATED STOCKHOLDER MATTERS

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>High</u>	<u>Low</u>
2004:		
Quarter ended March 31, 2004	\$ 1.85	\$ 1.03
2003:		
Quarter ended December 31, 2003	\$ 1.40	\$ 0.53
Quarter ended September 30, 2003	\$ 0.59	\$ 0.38
Quarter ended June 30, 2003	\$ 0.64	\$ 0.30
Quarter ended March 31, 2003	\$ 0.73	\$ 0.35
2002:		
Quarter ended December 31, 2002	\$ 0.74	\$ 0.33
Quarter ended September 30, 2002	\$ 0.50	\$ 0.26
Quarter ended June 30, 2002	\$ 0.75	\$ 0.38
Quarter ended March 31, 2002	\$ 1.20	\$ 0.61

The last price of our common stock as reported on the OTC Bulletin Board on April 29, 2004 was \$1.74 per share.

Holders

As of April 28, 2004 the number of stockholders of record of our common stock was 229. Based on broker inquiry conducted in connection with the distribution of proxy solicitation materials in connection with the Company's special meeting of shareholders in 2002, we believe that there are approximately 1,900 beneficial owners of its common stock.

Dividends

We have not paid any cash dividends to date, and have no intention of paying any cash dividends on our common stock in the foreseeable future. The terms of our outstanding series C preferred shares preclude us from declaring or paying a dividend on our common stock unless a dividend is also declared or paid, as applicable, on our series C preferred shares. The declaration and payment of dividends is also subject to the discretion of our Board of Directors and certain limitations imposed under the Minnesota Business Corporation Act. 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.

**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 prospectus contain forward-looking statements that involve risks and uncertainties. All forward-looking statements included in this prospectus 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" and elsewhere in this prospectus. The following should be read in conjunction with our audited financial statements included elsewhere herein.

Overview

We develop and market proprietary fingerprint identification biometric technology and software solutions. We pioneered the development of 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 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 and is the only finger identification algorithm that has been certified by the International Computer Security Association (ICSA).

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 finger biometric technology available. During the past two years, our focus has shifted to marketing and selling this technology. We have built a direct sales force of professionals with substantial experience in selling technology solutions to government and corporate customers. We expect to continue to add additional qualified personnel in 2004.

During 2003, we entered into a number of licensing and development agreements and generated approximately \$524,000 of revenue. Certain of these arrangements have resulted in our technology being used in commercial applications on a run time basis and we are beginning to generate recurring revenue. We will continue to focus a substantial amount of resources on our sales and marketing efforts and expect revenues to increase substantially during 2004. Our primary objective in 2004 is to generate revenue and increase the recognition, use and acceptance of our technology in the market. To accomplish this, all sales efforts are focused on moving evaluation and development relationships to run time license arrangements as quickly as possible. We continue to see increases in qualified leads resulting in evaluation licenses and run time licenses. Our biggest challenge is obtaining financial and human resources to pursue and follow up on all opportunities available to us.

Although recent security concerns relating to the identification of individuals has increased interest in biometrics generally, it has yet to gain widespread commercial acceptance. We continue to see increasing acceptance of biometric technology and believe the market for our technology is large enough for us to become a successful revenue generating company. Continued concerns regarding security and increased corporate spending on technology are key external conditions which may affect our ability to execute our business plan.

On March 30, 2004, we acquired all of the outstanding capital stock of Public Safety Group, Inc. ("PSG"), a privately-held provider of wireless solutions for law enforcement and public safety markets based in Winter Park, Florida, in exchange for an aggregate of 2,416,108 shares of our common stock, \$500,000 in cash, and our assumption of \$600,000 in aggregate net liabilities of PSG. The acquisition was completed pursuant to the terms of an agreement and plan of merger by and among the Company, BIO-Key Acquisition Corp., a wholly-owned subsidiary of the Company, PSG and all of the shareholders of PSG. As a result of this transaction, PSG became a wholly-owned subsidiary of the

Company and now constitutes a division of our business specializing in the law enforcement and public safety markets.

On March 31, 2004, we completed a private placement equity offering that resulted in approximately \$12,000,000 in gross proceeds to the Company. Based on available cash resources, existing funding obligations and projected revenue, we believe our existing financial resources will now be sufficient to sustain operations for at least the next twenty-four (24) months. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing, among other matters, as to which there can be no assurances.

Results of Operations

Year Ended December 31, 2003 As Compared To Year Ended December 31, 2002:

Revenues

We generated revenues of approximately \$524,000 during 2003 as compared to approximately \$155,000 during 2002. Our 2003 revenues consisted of approximately \$411,000 from license fees and approximately \$113,000 from products and services as compared to approximately \$131,000 from license fees and approximately \$24,000 from sales of products and services during 2002. We expect ninety percent (90%) of our future revenues to be generated from license fees and the balance from product sales. We expect revenues to continue to increase during 2004, as we enter into new licensing arrangements and our existing arrangements lead to recurring run time licenses.

Costs and Other Expenses

Selling, general and administrative expenses. Selling, general and administrative expenses increased approximately \$192,000 to approximately \$2,118,000 during 2003 as compared to approximately \$1,926,000 in 2002. Of the increase, approximately \$182,000 was related to increased sales and marketing activity, approximately \$137,000 was related to an increase in general administrative costs, approximately \$266,000 was related to an increase in costs for administrative personnel, and approximately \$76,000 was related to an increase in professional services. These amounts were offset by a decrease in marketing consulting costs of approximately \$469,000 in 2003. Although we continue to closely monitor expenses, we expect marketing, sales and technical support expenses to increase in 2004 as we continue to focus on generating revenue and supporting our growing customer base. Accordingly, we expect selling, general and administrative expenses to increase during 2004.

Research and Development. Research, development and engineering expenses decreased approximately \$47,000 to approximately \$1,037,000 in 2003 as compared to approximately \$1,084,000 in 2002. Of the decrease, approximately \$58,000 was related to a decrease in general development expense, and approximately \$44,000 was related to a decrease for services of outside programming sub-contractors. This was offset by an approximate \$55,000 increase in personnel costs. Having completed the development of our core technology, research and development expenses in 2004 will consist of enhancing existing software and reacting to customer feedback. We expect research and development costs to stabilize during 2004.

Interest Expense. Interest expense decreased approximately \$53,000 to approximately \$1,110,000 in 2003 as compared to approximately \$1,163,000 in 2002. The decrease was due to a net decrease during 2003 of the amortization of discounts applicable to convertible debt issued during 2001 arising from the warrants issued with such convertible debt and the beneficial conversion features of such debt. We recently converted \$6.5 million of long term debt and accrued interest into convertible preferred stock. Unless we are required to raise any necessary financing through issuance of debt securities, we expect interest expenses to decrease substantially in 2004.

Net Operating Loss Carryforwards

As of December 31, 2003, we had federal net operating loss carryforwards of approximately \$24,504,000. The carryforwards expire between 2011 and 2023. Such net operating carryforwards may be limited in the future in the event of a change in ownership of the Company as defined in the Internal Revenue Code.

Liquidity and Capital Resources

Net cash used in operating activities during 2003 was approximately \$2,857,000, and was principally due to operating losses. The operating losses were primarily funded by proceeds from the sale of secured convertible notes, and cash on hand at December 31, 2002.

Net cash provided by financing activities during 2003 was approximately \$3,948,000, which consisted of the issuance of approximately \$3,886,000 principal amount of long term notes and short term advances to The Shaar Fund Ltd. (the "Investor") between January and November 2003, and approximately \$62,000 upon exercise of options and warrants.

Working capital increased approximately \$8,384,000 during 2003 to approximately \$1,085,000 on December 31, 2003 as compared to a deficit of approximately \$7,299,000 on December 31, 2002. This increase is principally due to extending the maturity date of approximately \$9,300,000 principal amount of current maturities of long term obligations and approximately \$1,131,000 of accrued interest until October 1, 2005.

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

On October 31, 2003, we entered into an amendment to the January 27, 2003 note purchase agreement with the Investor to provide up to \$2,500,000 of additional financing pursuant to the terms of a secured promissory note (the "Secured Note"). Of this amount, \$600,000 was advanced at closing and \$1,900,000 was funded between December 3, 2003 and March 29, 2004. The Secured Note is due October 1, 2005, is secured by substantially all of our assets including our intellectual property, accrues interest at the rate of 7% per annum payable on maturity, and may be prepaid without penalty. The principal amount and accrued interest is convertible at the option of the Investor into either shares of our common stock at a conversion price of \$.75 per share or shares of our series C preferred stock (the "Series C Shares") at a conversion price of \$100 per share. The Secured Note also provided that in the event we completed a private placement of our equity securities resulting in gross proceeds in excess of \$5,000,000 on or before June 30, 2004, some or all of the principal and accrued interest shall, at the option of the Investor, be either converted into such equity securities at a conversion price equal to the sale price of such securities or repaid in cash. Upon the closing of our recent private placement equity offering, the Investor elected to convert \$347,500 of the principal amount of the Secured Note into shares of our common stock and warrants to purchase shares of our common stock, each issued to the Investor in connection with such private placement.

Pursuant to a recapitalization transaction completed on March 3, 2004, all existing promissory notes payable to the Investor, other than the Secured Note, together with all accrued and unpaid interest due thereon (approximately \$6,500,000) were cancelled and converted into 65,000 Series C Shares. Series C Shares are convertible into common stock at a conversion price of \$.75 per share. In the event that the trading price of our common stock is less than \$1.00 per share for thirty (30) consecutive days at any time after March 3, 2007, we will be required to redeem the Series C Shares at a redemption price of \$100 per share plus all accrued and unpaid dividends due thereon. In connection with the recapitalization transaction, the Investor transferred \$375,000 of the principal amount of the Secured Note to Thomas J. Colatosti, our Chairman of the Board of Directors.

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On March 30, 2004, the Investor elected to convert \$1,827,500 of principal and accrued interest due under the Secured Note into 18,275 Series C Shares. Also on March 30, 2004, the Investor elected to convert all of the issued and outstanding shares of our series B preferred stock and accrued and unpaid dividends thereon and all accrued and unpaid interest on such dividends into 5,257 additional Series C Shares. As of April 28, 2004, the Investor elected to convert 12,100 Series C Shares into an aggregate of 1,626,179 shares of our common stock.

On April 29, 2004, Mr. Colatosti elected to convert \$375,000 of the principal amount of the Secured Note into 3,750 Series C Shares.

We have agreed, at the Investor's request, to file a registration statement covering the public resale of the shares of common stock issuable upon conversion of the Series C Shares.

We do not expect any material capital expenditures during the next twelve months. On March 30, 2004, we completed the acquisition of PSG in exchange for an aggregate of 2,416,108 shares of our common stock, \$500,000 in cash, and our assumption of \$600,000 in net liabilities of PSG. Any liability or obligation of PSG in excess of such \$600,000 limitation, whether arising before or after the effective date of the merger, will be solely the responsibility of the former shareholders of PSG. In connection with this acquisition, we also issued 6,000 shares of our common stock to Harward Investments, Inc. ("Harward") pursuant to an arrangement involving the discharge of certain outstanding debt obligations of PSG to Harward as of March 30, 2004. Additional earnout consideration, determined as a proportion of revenues attained by the acquired business over fiscal years 2004 and 2005, may be paid to the former shareholders of PSG. The Company will make payments of such additional consideration on the last day of the month following each month in which the acquired business achieves specified revenue milestones during fiscal years 2004 and 2005. Such payments will be made in cash, unless the aggregate amount of earnout consideration exceeds sixty percent (60%) of the aggregate consideration paid by the Company in the merger transaction. Any such excess amounts will be paid in shares of our common stock priced as of two (2) days prior to the date on which any earnout payment becomes due.

Our future liquidity and capital requirements will depend upon numerous factors, including:

the ability to license our technology to original equipment manufacturers, systems integrators and application developers;

the ability to successfully integrate PSG's technology and customer relationships into our current business plan;

the costs and timing of product development efforts and the success of these efforts;

the ability to maintain and grow quality customer base; and

biometric technology market developments.

As of April 26, 2004, we had cash resources of approximately \$11,100,000. We currently require approximately \$400,000 per month to conduct our operations. During 2003, we entered into license agreements generating approximately \$524,000 of revenue and expect to continue to generate increasing revenue from existing and new relationships during 2004. Anticipated revenues are expected to defray operating expenses and reduce the need for additional financing, but are not expected to be sufficient for us to significantly expand operations.

On March 31, 2004, we entered into a securities purchase agreement with certain institutional and accredited investors pursuant to which we issued and sold an aggregate of 8,888,928 shares of our common stock and warrants (the "Warrants") to purchase an aggregate of 4,444,464 shares of our common stock. The investors paid an aggregate purchase price of \$1.35 for each share of common stock and Warrant to purchase 0.5 of a share of common stock, resulting in gross proceeds to the

Company of approximately \$12,000,000. We now believe our current cash resources and anticipated cash flow from operations will enable us to maintain operations at current levels for at least the next twenty-four (24) months. We may need to obtain additional funding to execute our plan to substantially grow operations and revenue and to conduct the sales, marketing and technical support necessary to generate and serve a significant customer base. To the extent that we would require such additional funding, 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 its needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or unavailable or we fail to generate any meaningful revenue, we may be required to further reduce operating expenses, suspend operations, seek a merger or acquisition candidate or ultimately liquidate our assets.

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

DESCRIPTION OF THE BUSINESS

Overview

The Company was formed in 1993 and is in the business of developing and marketing proprietary biometric technology and software solutions. Biometric technology, the science of analyzing specific human characteristics which are unique to each individual in order to identify a specific person from a broader population, is an emerging technology. Fingerprint analysis is an accurate and reliable method to distinguish one individual from another and is viewed as less intrusive than many other biometric identification methods. As a result, fingerprint analysis has gained the most widespread use for biometric identification. Biometric technology represents a novel and accurate approach to identity verification and authentication which is now being used in limited applications and is gaining acceptance in the government, commercial and consumer markets.

We have pioneered the development of high performance automated finger identification technology that can be used without the aid of non-automated methods of identification such as a personal identification number (PIN), password, token, smart card, ID card, credit card, passport, driver license or other form of possession based or knowledge based identification.

Our advanced BIO-key identification technology improves both the accuracy and speed of finger-based biometrics and is the only finger identification algorithm that has been certified by the International Computer Security Association. Our proprietary biometric technology scans a person's fingerprint and identifies a person, typically within a few seconds, without the use of any other identifying data. We believe our fingerprint identification technology will have a broad range of possible applications relating to information security and access control, including:

Securing Internet sites and electronic transactions

Securing access to logical networks and applications

Securing access to buildings and restricted areas

Securing mobile devices such as cell phones and PDA's

In addition to these technologies, we recently acquired Public Safety Group, Inc. ("PSG"), a privately held leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology, PocketCop®, is a software solution that provides police officers and other security personnel instantaneous access to important criminal, civil and private database information in a wireless environment. PocketCop® is the first and only copyrighted handheld application that allows law enforcement officers to access state and federal databases over the wireless network for PalmOS, Windows CE and PocketPC. With the use of a portable wireless handheld device and PocketCop® application software, an authorized user can access suspect information such as wanted status, warrant status, vehicle registration and driver license status. PSG has deployed its technology in numerous police departments in the United States, including the statewide deployment for the Massachusetts State Police and has developed a number of important strategic marketing partnerships including Hewlett Packard.

Our current business plan is to:

License our core technology "VST" to original equipment manufacturers, systems integrators and application developers to develop products and applications which utilize our core technology.

License WEB-key , our web-based biometric authentication solution.

Provide for "device independent" finger identification matching for virtually any application utilizing the latest advances in scanning technology.

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License PocketCop®, our wireless software solution for law enforcement and public safety markets.

We actively market and sell our technology principally to biometric system integrators and value added resellers focused on the security and logical access markets. A number of our customers have begun to deploy our technology on a run-time basis which is generating recurring quarterly revenues. After years of technology and product development, we have evolved from a development stage company to a revenue generating company.

Market Overview

Recent concerns relating to Homeland Security and the need for identification of individuals has resulted in an increased interest in biometrics. Biometric based solutions currently compete with more traditional security methods such as keys, cards, personal identification numbers and security personnel, as well as competing biometric technologies including voice, face, iris and hand geometry. The market for business-to-business and business-to-consumer transactions is substantial and continues to grow. Such transactions are subject to fraud resulting in unauthorized individuals gaining access to confidential information. Identity theft is one of the most pressing issues facing corporations today. We believe our biometric technology provides a more reliable method for confirming the identity of persons in local or remote locations than existing traditional methods.

Additionally, law enforcement and public safety are large and growing markets. The ability to quickly and accurately collect data from a variety of database sources and formats and deliver it to first responders opens a new framework to bring real time intelligence to security officers deployed in the field. With our acquisition of PSG, we believe there is a substantial market opportunity to integrate our VST and WEB-key biometric technologies with the PSG mobile solution.

Biometric technology is becoming an acceptable approach to physical and logical security. Acceptance of biometrics as an alternative to traditional security methods depends upon a number of factors including:

The reliability of biometric solutions

Public perception regarding privacy concerns

Costs involved in adopting and integrating biometric solutions

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

Technology

We have developed proprietary fingerprint identification technology consisting of:

VST (Vector Segment Technology), our patent pending core algorithm which creates a mathematical representation of a fingerprint based on its particular characteristics.

Software which translates and standardizes the image of the fingerprint for computer analysis ("Biometric Solution").

SDK (Developers Tool Kit), a biometric application development tool which facilitates integration of our technology for vertical market applications.

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Utilizing these technologies, we continue to develop identification products and software solutions which are designed to assure that only individuals comprising an approved fingerprint in an online or embedded database are allowed access to an application through real time authentication.

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

De-coupling of Technologies. Over the years we have modified our core Vector Segment Technology by de-coupling the core identification algorithm from the reader technology. Our finger identification technology is hardware independent and can be integrated with virtually any finger reading device. Enrollments or capture of an individual's biometric identification can be done on one type of scanner and looked-up or identified for a match on another type of scanner. This capability is unique in the biometric market and allows our software to be used and integrated with almost any finger scanning hardware.

Identification Verses Verification Technology. We believe our Vector Segment Technology is superior to similar technologies utilized by our competitors. Unlike many of the biometric technologies currently available, our technology identifies the fingerprint of an unknown person by searching a database to determine whether the current scanned mathematical representation matches any previously stored mathematical representation. Most of our fingerprint competitors simply verify that the fingerprint image of a known person matches a previously stored copy or model of that individual's fingerprint. By their very nature, such verification systems require an additional item of data such as a PIN or access card to initially identify the user. Verification systems do not eliminate the need for cumbersome access cards, keys or PIN numbers and the administrative costs associated with the distribution and replacement of such data. By contrast, our identification technology typically does not require any identifying data other than a person's fingerprint. We believe this provides us with a meaningful competitive advantage in the marketplace.

Current Offerings

The following is a description of the status of each of our current offerings.

VST (Vector Segment Technology) SDK (Systems Developer Kit). Our SDK is a means of delivering our patent-pending finger identification algorithm, called Vector Segment Technology (VST), as an integrated software into existing and new applications. The VST SDK is a software kit licensed to original equipment manufacturers, systems integrators and application developers for the purpose of permitting them to develop biometric applications for distribution to their respective customers.

The VST SDK improves both the accuracy and speed of fingerprint-based security systems. Traditional fingerprint analysis classifies fingerprints by mapping their Minutiae Reference Points distinct features in specific locations. Most automated fingerprint identification systems create a template of these minutiae reference points and uses it as the basis for comparison and verification. However, strictly minutiae-based templates cannot achieve a high level of differentiation, making them unsuitable for real-time identification applications. To achieve rapid verification, they often compromise on detail, supplementing the fingerprint template with a user ID or password. This enables quick

one-to-one matching, but not true identification. VST transcends the conflict between differentiation and speed by mapping the fingerprint in an entirely new way. Instead of focusing on minutiae point coordinates, VST also analyzes the vector segment relationships in the entire fingerprint pattern. The result is a highly informative representation of the finger packaged as a mathematical model.

Unlike other algorithms, VST processes hundreds of data relationships for each element in the finger model. Because this data is concisely expressed, VST makes it possible to rapidly identify people based on their finger alone, without a user ID, password or smart card. This allows for the true identification of users, not just verifying the identity of a known user. No security system can achieve total security as long as a user's identifying data can be stolen or duplicated. Whereas a user ID, a password or even a scanned fingerprint image can be stolen, the mathematical model produced by VST cannot. Once a finger is scanned and converted to a VST mathematical model, the scanned image is destroyed. All that remains is a mathematical model that cannot be decoded to obtain the original fingerprint image.

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

WEB-key is an Internet ready three-tiered Internet application architecture software security solution. We license WEB-key as an integrated solution of our VST algorithm for securing e-commerce, e-business, and web-based transaction applications. All WEB-key communication is triple-encrypted to prevent secure information from being intercepted over the Internet. Using WEB-key's browser plug-in, users enroll finger identification at a WEB-key enabled Web site from their own PC. After enrollment, WEB-key requests finger identification every time a user begins a secure session. WEB-key's interface guides users through the few steps necessary to gain an accurate finger identification. The entire identification process takes less time than typing a user ID and password.

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

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

WEB-key consists of three basic components:

finger print scanner

Vector Segment Technology processing software tightly and securely integrated with a web browser

identification database residing on a web server

The user simply logs-on a computer or application residing on a computer using their fingerprint. WEB-key processes a raster scan image which is enhanced using WEB-key software integrated into

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the web browser. The image enhancing employs a variety of proprietary techniques to improve accuracy and protect against spoofing. The WEB-key software then converts the enhanced image into a unique mathematical representation of the fingerprint using Vector Segment Technology. An encrypted print model is generated for transmission across the Internet to the central WEB-key registry. The WEB-key web server de-encrypts the mathematical model which operates as an index key for searching the database for a match. The web server matches the Vector Segment Technology BIO-key against a database of registered users to obtain a match. If a match is found, the user is allowed access to the protected content on a connected web server.

WEB-key provides a reliable and secure user authentication solution. WEB-key takes advantage of new security features in Microsoft's Internet Explorer versions 5.5 SP2 and 6.0, in addition to 1024 bit enhanced encryption capabilities integrated with public/private key pairs. WEB-key has also been integrated with Oracle9iRAC and 10g which offers advanced speed, scalability, and reliance to WEB-key's database tier. Additional tools and software based on VST technology are under development.

We do not currently manufacture any hardware and do not intend to in the future. We rely on OEMs, systems integrators and other licensees of our software to supply the necessary hardware, including optical readers. We have relationships with hardware manufacturers which enable us to supply readers as an integrated solution when necessary. Our technology includes proprietary open architecture communication software which allows virtually any reader to be integrated with our technology. Our software has been integrated with readers manufactured by Polaroid, Authentec, Ethentica, CrossMatch, ST Micro, Secugen, Fujitsu, TesTec, Silex, StarTek, Targus, and other independent manufactures.

PocketCop®. PocketCop® is a software solution that provides police officers and other security personnel instantaneous access to important criminal, civil and private database information in a wireless environment. PocketCop® is the first and only copyrighted handheld application that allows law enforcement officers to access state and federal databases over the wireless network for PalmOS, Windows CE and PocketPC. With the use of a portable wireless handheld device and PocketCop® application software, an authorized user can access suspect information such as wanted status, warrant status, vehicle registration and driver license status. The highest available encryption methods are implemented to provide secured transactions between the handheld device and the local agency's server meeting and exceeding state and federal certification standards.

Potential Market

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

corporations that increasingly rely upon the exchange and distribution of proprietary information among staff using intranet or other private networks

business-to-business e-commerce among trading partners which share confidential information on a secure basis

business-to-consumer e-commerce where the e-commerce service provider wants to restrict access to paying subscribers

Government Regulations such as HIPPA and Gramm Leach Bliley which are forcing the secure management of user identities

Application software providers that require secure access to applications such as Single Sign On, HR, ERP, Point of Sale, Check Cashing, and Medical Records

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

The current solution to these issues is the association of passwords and PIN numbers with individuals. This solution requires employees or users to remember or retain a growing number of keys cards, passwords and PIN numbers and employers or Internet companies to periodically change passwords and PIN numbers to maintain their integrity. Since such information can be stolen or shared, they provide no assurance that the user is actually who they claim to be. WEB-key has been designed to address each of these concerns. We believe that augmenting or replacing traditional passwords presents a substantial market opportunity. Our technology could virtually replace and eliminate the need for passwords and the associated administrative costs while providing a higher assurance of identity security and user convenience. Government, aviation/transportation and enterprise security present significant additional opportunities.

Marketing and Distribution

Our marketing and distribution efforts consist of:

Developing strategic alliances with technology leaders such as Oracle, Netegrity, Hewlett Packard, Autodesk and others

Promoting biometric technology and our offerings through industry trade shows, public speaking engagements, press activities and partner marketing programs

Directing licensing efforts to, among others, original equipment manufacturers ("OEMs"), application developers and system integrators.

Building a reseller, integrator, partner network and a direct sales team

Direct Selling Efforts. Our current selling efforts are conducted primarily through our expanded direct sales organization. Our sales team consists of our vice president of sales, three area sales directors, a business integration manager to support sales efforts with partners, ISV's, OEM's and the indirect channel, and a senior sales support representative to support all direct and indirect sales campaigns.

Strategic Alliances and Partnerships. We attend and actively participate in various product conferences and conventions in the technology and security industries to generate market awareness of biometric technology generally, and our offerings specifically. During the past year, we have strengthened our alliance with Oracle having been recognized as Certified Partner in the Oracle Partner Network. We support the Oracle e-business suite of applications and provide the biometric enabler for the Oracle Single Sign on product. We are a development partner with Oracle which provides the underlying database used for true user identification and "on demand" alias checking. As a development partner, we participate in Oracle Trade Shows such as Oracle Open World and Oracle Apps World.

We have formed alliances with other industry leaders. We are a Premier Partner of Netegrity, a leader in the identity management, whose Identity technology is used by over 800 corporate accounts with over 2.5 million users. We have developed a biometric interface allowing users of Netegrity to enhance the traditional methods of user identification, which we intend to aggressively market through the Netegrity Partner and Integrator Network. We are also working with Choicepoint, a leader in civil

identification and background checks, to thwart identity theft in the commercial marketplace. One solution being deployed is a check cashing application where individuals would use fingerprint biometrics to truly verify that they are the individual carrying the credentials and authorized to conduct the transaction. Other solutions utilizing the strength of Choicepoint products and services are currently being developed.

We also have established, through PSG, a strategic marketing partnership with Hewlett Packard to provide PSG's technology to the Massachusetts State Police on a statewide basis.

Public and Private Sector. The events of September 11, 2001 have heightened the need for securing data dissemination throughout and between government agencies and automating the positive identification of personnel. We believe our finger identification technology coupled with the capabilities of our alliance partners are the most advanced solutions capable of meeting these needs. In this regard, we were recently awarded a contract to ensure the secure access, transmission and retrieval of critical government and public sector information. We are also working with the National Sheriff's Association and the Pegasus Research Foundation to provide biometric authentication for secure sharing of critical data to Sheriff's offices and first responders across the country. We expect the initial rollout to grow from the initial 220 Sheriff's locations.

Licensing. We target both Internet infrastructure companies and large portal providers as licensees of our WEB-key solution. On the Internet infrastructure side, we seek 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, we are 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. During 2003, we commenced a direct selling effort of WEB-key and VST and entered into license agreements with OEMs and system integrators to develop applications for distribution to their respective customers. We expect to continue to generate revenue during the remainder of 2004 from existing and new customer relationships.

We are also addressing the security needs of application providers in the following vertical markets:

Government: Northrup Grumman has deployed a pilot within the Department of Defense to cross credential visitors and contractors to certain military bases using our technology.

Education: Educational Biometrics has incorporated our technology to enable school children to pay for school lunch programs and checkout library books using their fingerprints. VST technology enabled Educational Biometrics to easily enroll these children and reduce the time students spend in lunch line and administrative costs of managing passwords and collecting payments.

Healthcare: Biometric Technologies, a licensee in South Africa, is utilizing our technology to minimize fraud for health service providers. The integration of our biometric solution to truly identify individuals presenting insurance cards will reduce losses due to identity fraud.

Financial: We are working with several partners focusing on financial applications such as check cashing, point of sale systems and employee trusted identification cards, as well as customer facing applications over the internet.

Competition

The markets for our products and technologies are developing and are characterized by intense competition and rapid technological change. No assurance can be given that our competitors will not develop new or enhanced technologies that will offer superior price, performance or function features or render our products or technologies obsolete.

In addition to existing commonplace methods of restricting access to facilities such as pass cards, PIN numbers, passwords, locks and keys, there are numerous companies involved in the development, manufacture and marketing of fingerprint biometrics products to government, law enforcement and prison markets. These companies include, but are not limited to, PRINTRAK International, IDENTIX, and Bioscript

Most current automated fingerprint identification product sales have been for government and law enforcement applications, which are typically priced higher than our products and licensing arrangements. Although most companies targeting consumer application markets have completed the development of their products, biometric products and technologies have not been widely accepted in the commercial markets. Most companies competing for commercial opportunities are in the business of selling scanning devices and tie their algorithm to a specific device. We have created a "device independent" algorithm that provides for flexibility in choosing the correct device, optical or tactile sense to fit the application served.

With current non-biometric technologies, the user must typically possess a key, card, or bit of information such as a PIN number or password. These systems are easily defeated by obtaining possession of the key, card, or password, or by counterfeiting the key or card. The Company's biometric technology is intended to replace such systems and substantially reduce the related security breaches. Although biometric based "verification" systems can identify a person and prevent unauthorized persons from entering into a restricted area, such systems do not eliminate the need for PIN numbers, cards, keys or tokens. By contrast, our identification technology typically does not require the use of any such additional identifier other than the person's fingerprint and "identifies" rather than "verifies" the subject. We believe that such end-user convenience creates a meaningful competitive advantage for the Company. There can be no assurance, however, that our competitors will not develop similar or superior "identification" technology, which could have a material adverse effect on our financial condition and results of operation. We will also be competing for market share with other biometric technologies including hand geometry, iris scanning, retinal scanning, and signature verification, as well as existing lock/security/card technology.

Intellectual Property Rights

Our technology consists of knowledge and information relating to computer software and methods, which is used to create an automated process of capturing, processing, analysis and matching of a fingerprint for authorization purposes. Matching can be performed against existing databases or individual samples. We have patent application claims on our algorithm technologies, called Vector Segment Technology, our authentication solutions security framework, called WEB-key , our trusted device communication methodologies, and our secure template processes. There can be no assurance that any patents will be issued, or that, if issued, we will have the resources to protect any such issued patent infringement. Although we believe that its technology does not infringe upon patents held by others, no assurance can be given that such infringements do not exist.

Our technology consists of software. We take measures to ensure copyright and license protection for our software releases prior to distribution. Where possible, the software is licensed in an attempt to ensure that only licensed and activated software functions to its full potential. This provides a mechanism to combat cloning of products.