CMS ENERGY CORP
Form 4
August 29, 2007

FORM 4

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

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
BARBA GLENN P

(Last) (First) (Middle)

ONE ENERGY PLAZA

(Street)

JACKSON, MI 49201

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
CMS ENERGY CORP [CMS]

3. Date of Earliest Transaction (Month/Day/Year)
08/27/2007

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)
VP, Controller, CAO

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock								608	I	401(K)
Common Stock								195	I	Trust
Common Stock	08/27/2007	08/27/2007	A		4,500 (1)	A	$ 15.9	55,758	D	
Common Stock	08/27/2007	08/27/2007	F		4,165	D	$ 15.9	51,593	D (2)	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
BARBA GLENN P ONE ENERGY PLAZA JACKSON, MI 49201			VP, Controller, CAO	

Signatures

Catherine M. Reynolds, Attny-in-Fact	08/28/2007
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) These shares represent additional vested shares to the performance-based shares granted on August 27, 2004 resulting from the achievement of performance objectives exceeding the performance factor established in accordance with the Performance Incentive Stock Plan of CMS Energy Corporation.

(2) Total includes 33,674 shares of Restricted Stock, of which 26,480 shares are nominal. (The nominal shares received will be determined by the passage of time and achievement of performance objects under the Performance Incentive Stock Plan of CMS Energy Corporation.)

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ession. 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 also intended to secure other Internet applications such as restricting access to specific Web pages, specific information contained on a Web-site or specific applications. The Company believes it has the opportunity to be the first supplier of a reliable 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. 5 WEB-key consists of three basic components: * a finger print scanner * Vector Segment Technology processing software tightly and securely integrated with a web browser * an identification database residing on a web server. The user simply logs-on a computer or application residing on a computer using their fingerprint in lieu of a PIN number, password, user name or smart card. WEB-key begins by processing a raster scan image which is enhanced using WEB-key software integrated into the web browser. The image enhancing employs a variety of proprietary techniques to improve accuracy and protect against spoofing. The WEB-key software then converts the enhanced image into a unique mathematical representation of the fingerprint using Vector Segment Technology. An encrypted print model is generated for transmission across the Internet to the central WEB-key registry. The WEB-key web server de-encrypts the mathematical model which operates as an index key for searching the database for a match. The web server matches the Vector Segment Technology BIO-key against a database of registered users to obtain a match. If a match is found, the user is allowed access to the protected content on a connected web server. WEB-key provides a reliable and secure user authentication solution. WEB-key takes advantage of new security features in Microsoft's Internet Explorer versions 5.5 SP2 and 6.0, in addition to 1024 bit enhanced encryption capabilities integrated with public/private key pairs. WEB-key has also been integrated with Oracle9iRAC, which offers advanced speed, scalability, and reliance to WEB-key's database tier. Additional tools and software based on VST technology are under development. The Company does not currently, and does not intend in the future, to manufacture any hardware. The Company relies on OEMs, or systems integrators and other licensees of its software to supply the necessary hardware, including optical readers. The Company has relationships with hardware manufacturers which enable the Company to supply readers to potential clients as an integrated solution when necessary. Currently, the Company has integrated its software with readers manufactured by Polaroid, Authentec, Ethentica, Siemens, and other independent manufactures. The Company's technology includes proprietary open architecture communication software which allows virtually any reader to be integrated with the Company's technology within several weeks. 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 6 Although electronic commerce has many benefits, the geographical separation of buyers from sellers creates a significant problem arising from the opportunity for fraud. Firewall and encryption software address important aspects of security but do not address the fraud problem inherent in the potential anonymity of a remote user. Corporate intranets are an equally attractive and compelling market. Corporations increasingly rely upon intranet infrastructure for the dissemination of proprietary business data throughout an organization. Since access rights to different classes of data vary among employees, password identification and authorization is integral to all corporate networks. The current solution to these issues is the association of passwords and PIN numbers with individuals. This solution requires employees or users to remember or retain a growing number of keys cards, passwords and PIN numbers and employers or Internet companies to periodically change passwords and PIN numbers to maintain their integrity. Since such information can be stolen or shared, they provide no assurance that the user is actually who they claim to be. WEB-key has been designed to address each of these concerns. The Company believes that replacement of traditional passwords presents a substantial market opportunity. The Company's 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 The Company's marketing and distribution efforts consist of: * Development of strategic alliances with technology leaders * General promotion of biometric technology and the Company's offerings * Direct technology licensing efforts to, among others, OEMs, application developers and operators of private network. The Company's current marketing efforts are conducted primarily through direct selling efforts of its Chief Executive Officer, President and other marketing personnel to OEMs, application developers and operators of private networks. The Company attends and actively participates in various product conferences and conventions in the technology and security industries to generate market awareness of biometric technology generally and the Company's offerings specifically. In this connection, in October 2000, the Company began a collaborative presentation effort with Intel Corporation whereby the Company and Intel created a proof-of-concept demonstration of the Company's WEB-key product. The demonstration was created across the Intel IA32 and Itanium family processor products and was first presented at the Intel Developer Forum (IDF) in February 2001. Proof of concept was presented at WinHec in Anaheim, California on March 25-27, 2001 and RSA in San Francisco, California during April 2001. Intel continues to showcase the Company's biometric IT security solution as a lead application for Intel's next generation Itanium Internet/e-business server and as a solution working with Oracle 9i and Oracles database. Additionally the WEB-key product has been presented in alliance with and part of Intel's exhibit at the Oracle Open World in Berlin and San Francisco. Although the Company intends to participate in events and other conferences with Intel, there can be 7 no assurances that Intel will continue to allow the Company to participate with it at any such events or conferences. The Company has been aggressively marketing its WEB-key and SDK technology to leads generated from these efforts. The Company has also entered into alliances and/or joint sales and marketing arrangements with Oracle, Intel, and Siebel Systems to develop and implement new security systems utilizing the Company's technology for the Federal Government. The events of September 11th have heightened the need for securing data dissemination throughout and between government agencies and automating the positive identification of personnel. The Company believes that its finger identification technology coupled with the capabilities of its alliance partners are the most advanced solutions capable of meeting these needs. The Company is targeting both Internet infrastructure companies and large portal providers as licensees of its WEB-Key solution. On the Internet infrastructure side, the Company is currently seeking to partner with Internet server manufacturers, providers of database and data warehouse engine software, horizontally positioned application engines, firewall solution providers and peripheral equipment manufacturers. On the portal side, the Company is currently targeting financial service providers such as credit and debit card authorization and issuing institutions, Internet retailers, business-to-business application service providers (ASPs) and corporate intranets. WEB-key is available for licensing and during 2002, the Company commenced a direct selling effort. During the second quarter of 2002, the Company has entered into license agreements with OEMs and systems integrators to develop applications for distribution to their respective customers. The Company expects to continue to generate revenue during the remainder of 2002 from existing and new customer relationships. For the following reasons, the Company has yet to generate any significant revenue. The Company competes in a new and evolving market and offers a novel software solution. This has resulted in a long sales cycle as commercial markets continue to evaluate biometrics as a viable alternative to more traditional security methods such as personal identification numbers, passwords and the like. In addition, during 2000 and 2001, the Company was focused on developing and refining its technology and introducing its technology to the market through participation in technology conferences and trade shows. The Company did not begin a direct selling effort until 2002. This effort has resulted in a limited number of sales in the second quarter of 2002. COMPETITION The markets for the Company's products and technologies are developing and are characterized by intense competition and rapid technological change. No assurance can be given that the Company's competitors will not develop new or enhanced technologies that will offer superior price, performance or function features or render the Company's products or technologies obsolete. As of the date of this Report, the Company has yet to license its technology or manufacture, market, or sell its products on a wide-scale commercial basis. 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 8 fingerprint biometrics products to government, law enforcement, prison and consumer markets. These companies include, but are not limited to, PRINTRAK International, IDENTIX, Safelink, DigitalPersona, Bioscript and BioLink. Most current automated fingerprint identification product sales have been for government and law enforcement applications, which are typically priced higher than the Company's products and licensing arrangements. Although most of the companies specifically targeting consumer application markets have completed the development of their products, biometric products and technologies have not been widely accepted in the commercial markets. 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, the Company's 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. The Company believes that such end-user convenience creates a meaningful competitive advantage for the Company. There can be no assurance, however, that the Company's competitors will not develop similar or superior "identification" technology, which could have a material adverse effect on the Company's financial condition and results of operation. The Company 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. Many of the Company's competitors have substantially greater financial resources and experience in marketing Internet security applications than the Company. In addition, the Company's WEB-key(TM) offering is a unique approach to Internet security, requires the distribution and use of additional peripheral hardware, namely an optical reader, and has not been adopted by any company conducting business over the Internet. For these and other reasons, there can be no assurance that the WEB-key(TM) solution will gain any meaningful market acceptance or that the Company will be able to complete effectively in its chosen markets. INTELLECTUAL PROPERTY RIGHTS The Company's technology consists of knowledge and information relating to computer hardware and software which is used to create an automated process of imaging a fingerprint, formatting the fingerprint for computer analysis, and identifying and verifying the print relative to an existing database of fingerprint information. The Optic Technology and the Company's Biometrics Solution (STBS) and Vector Segment Technology are owned by the Company. The Company has filed a patent application relating to both the Optic Technology and Biometrics Solution (STBS) components of its technology wherein several claims have been allowed. The Company has also filed a patent application with respect to the Vector Segment Technology. There can be no assurance that any additional patents will be issued, or that, if issued, the Company will have the resources to protect any such issued patent infringement. Although the Company believes that its technology does not infringe upon patents held by others, no assurance can be given that such infringements do not exist. 9 Part of the Company's technology consists of software or hardware implementations of software ("firmware"). The Company intends to take measures to ensure copyright protection for its software and firmware releases prior to distribution. Where possible, the firmware/software is serialized in an attempt to ensure that only matched sets will function together. This provides both a mechanism to combat cloning of the Company's products and a method for standardizing products. The Company believes it has developed common law trademark rights in the terms SACMan(TM), SACcat(TM), SAC_Remote(TM), BIO_Key(TM), SACSecure(TM), SACcipher__, WEB-key(TM) and SACbook(TM) and has filed federal trademark applications. The Company does not claim any additional trademarks. RESEARCH AND DEVELOPMENT During fiscal years ended December 31, 2000 and 2001 the Company spent approximately $1,136,000 and $948,000, respectively, on research and development. The Company's limited customer base did not directly bear these costs, which were principally funded through, outside sources of equity and debt financing. During 2002, the Company's research and development effort will be focused on the continued evolution of its Web based authentication solution and furthering the VST algorithm and SDK. GOVERNMENT REGULATION The Company is not currently subject to direct regulation by any government agency, other than regulations generally applicable to businesses. However, in the event of any international sales or overseas manufacturing, the Company would likely be subject to various domestic and foreign laws regulating such exports and export activities. ENVIRONMENTAL REGULATION As of the date of this Report, the Company has not incurred any material expenses relating to the compliance with federal, state or local environmental laws and does not expect to incur any material expenses in the foreseeable future. EMPLOYEES AND CONSULTANTS The Company currently employs twelve (12) individuals on a full-time basis; six (6) in engineering, research and development, three (3) in finance and administration and three (3) in sales and marketing. The Company also utilizes four (4) consultants who provide marketing, engineering and management services to the Company. The Company anticipates retaining additional marketing personnel within the next twelve (12) months to execute its business plan. 10 RISK FACTORS The following material risk factors, among others, may affect the Company's financial condition and results of operations. BUSINESS AND FINANCIAL RISKS BASED ON OUR LIMITED WORKING

CAPITAL, NEGATIVE NET WORTH AND SUBSTANTIAL LOSSES, OUR AUDITORS HAVE RAISED SUBSTANTIAL DOUBT ABOUT OUR ABILITY TO CONTINUE IN BUSINESS. We have met our working capital requirements through financing transactions involving the public or private placement of our securities. We do not expect our current working capital to support our operations beyond August 2002 and we are in need of substantial additional capital to fund operations. Since our inception, we have not generated any significant revenue and have experienced substantial losses, including $2,283,774 during 2001. We also have limited working capital and a negative net worth. As a result of these factors, our independent auditors have included an explanatory paragraph in their opinion for the year ended December 31, 2001 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. WE ARE DEVELOPMENT STAGE COMPANY, HAVE GENERATED MINIMAL REVENUE AND HAVE SUSTAINED SUBSTANTIAL OPERATING LOSSES. WE EXPECT LOSSES TO CONTINUE 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, 2001, we have accumulated losses of $18,339,455 and negative cash flow from operations of $13,915,623. As of December 31, 2001, we had working capital of $392,533 and a negative net worth of $3,896,999. Since our inception, we have focused almost exclusively on developing our core technology and have not had any success marketing our technology. In order to generate revenue, we will have to retain additional marketing personnel and incur substantial marketing 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 generate any significant revenues. For these reasons we anticipate that net losses will continue. WE NEED SUBSTANTIAL ADDITIONAL FINANCING TO EXECUTE OUR BUSINESS PLAN WHICH MAY NOT BE AVAILABLE. IF WE ARE UNABLE TO RAISE ADDITIONAL CAPITAL, WE MAY NOT BE ABLE TO CONTINUE OPERATIONS. We need substantial additional capital to expand our marketing and sales efforts. Our current resources are insufficient to fund operations beyond August 2002. We believe we need an additional $5,000,000 to $7,000,000 to execute our business plan and support operations through 2003. Although The Shaar Fund has committed to provide an additional $1,080,000 in incremental 11 monthly advances through August, 2002, this obligation is conditioned upon events outside of our control, including the average trading price of our common stock exceeding $1.00 per share during the month preceding any advance. For these reasons, we are currently seeking to obtain additional financing through the issuance of debt or equity securities on a negotiated private placement basis with institutional and accredited investors. We have not and can not assure you that we will ever be able to secure any such financing on terms acceptable to us. If we can not obtain such financing, we will not be able to execute our business plan or continue operations. OUR OUTSTANDING 5% DEBENTURE AND PREFERRED STOCK ARE CONVERTIBLE INTO SHARES OF COMMON STOCK AT A DISCOUNT TO THE TRADING PRICE AT THE TIME OF CONVERSION. IF THE TRADING PRICE OF OUR COMMON STOCK DECLINES, THESE SECURITIES WILL BE CONVERTED INTO A GREATER NUMBER OF SHARES RESULTING IN SUBSTANTIAL DILUTION TO OUR EXISTING SHAREHOLDERS WHICH COULD HAVE A SIGNIFICANT NEGATIVE EFFECT ON THE TRADING PRICE OF OUR COMMON STOCK. Our 5% debenture and preferred stock are convertible into shares of common stock at a per share conversion price equal to the lesser of $.75 or a 22% discount to the average of the closing bid prices of our common stock during the five trading days preceding conversion. As a result of these provisions, in the event the trading price of our common stock declines, we will be required to issue a greater number of shares of common stock upon conversion of the debenture and preferred stock. This could result in the issuance of a substantial number of additional shares resulting in substantial dilution to our existing shareholders. For example, if the trading price of our common stock declines from $.92 to $.50, we would be required to issue 265,846 additional shares of common stock upon conversion of the debenture and 2,637,839 additional shares of common stock upon conversion of the preferred stock. The issuance of these additional shares could have a substantial negative effect on the trading price of our common stock. The terms of the debenture and preferred stock prohibit the holder from converting these securities into common stock if the conversion would result in the holder owing in excess of 4.99% of our outstanding shares. Although this limits the holder's right to convert these securities into more than 4.99% of our outstanding shares at any one time, it does not prevent the holder from immediately reselling all shares acquired upon conversion and then converting additional securities into up to an additional 4.99% of our outstanding shares. Accordingly, these provisions do not limit the number of shares we may be required to issue upon conversion of these securities. This will result in substantial dilution to our existing shareholders and could have a significant negative effect on the trading price of our common stock. OUR TECHNOLOGY HAS NOT GAINED MARKET ACCEPTANCE AND WE DO NOT KNOW WHETHER A MARKET WILL DEVELOP FOR OUR TECHNOLOGY IN THE FORESEEABLE FUTURE TO GENERATE ANY REVENUE. 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 12 For these reasons, we are uncertain whether our technology will gain any acceptance in any commercial markets or that demand will be sufficient to create a market large enough to produce any meaningful 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(TM) SOLUTION TO GENERATE ANY REVENUE. Our Web-key(TM) authentication initiative represents a new approach to Internet security which has not been adopted by any company which distributes goods, content or software applications over the Internet. The implementation of our WEB-Key(TM) solution requires the distribution and use of an optical reader 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 an optical reader 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 WHICH ARE NECESSARY TO GENERATE REVENUE. Although we have completed the development of our core technology, it has not been used by any business customer. 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 not gained any meaningful acceptance in the market, any delays would likely have a more detrimental impact on our business than if we were a more established company. WE HAVE NOT DEVELOPED ANY EFFECTIVE DISTRIBUTION CHANNELS FOR OUR TECHNOLOGY. We market our technology through licensing arrangements with: * Original equipment manufacturers, systems 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 * operators of private networks Our success will depend upon the ability of these manufacturers to effectively integrate and market reliable and affordable products which utilize our technology and upon commercial entities adopting biometric solutions. While we have commenced a significant marketing effort, we have not developed any effective distribution channels and may not have the resources or ability to sustain these efforts or generate any meaningful sales. 13 IN ORDER TO GENERATE REVENUE, WE ARE DEPENDENT UPON INDEPENDENT ORIGINAL EQUIPMENT MANUFACTURERS, SYSTEMS INTEGRATORS AND APPLICATION DEVELOPERS WHICH WE DO NOT CONTROL. AS A RESULT, IT MAY BE MORE DIFFICULT TO GENERATE SALES. As a technology licensing company, we are dependent upon original equipment manufacturers, systems integrators and application developers to integrate our technology into products and technologies which they develop and sell. Licensing revenue from our technology is dependent upon the success of these third parties in developing and distributing products and applications which incorporate our technology. We have no control over these licensees and can not assure you that any of them will 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 EXECUTIVE OFFICERS AND NEED ADDITIONAL MARKETING AND TECHNICAL PERSONNEL TO SUCCESSFULLY MARKET OUR TECHNOLOGY. WE CAN NOT ASSURE YOU THAT WE WILL BE ABLE TO RETAIN OR ATTRACT SUCH PERSONS. A loss of one or more of our current officers could severely and negatively impact our operations. We have employment contracts with Jeffry R. Brown, our Chief Executive Officer, H. Donald Rosacker, II, our President, and Mira LaCous, our Vice President of Technology. Although these employment contracts do not prevent such persons from resigning, they do contain non-compete clauses which are intended to prevent these persons from working for a competitor within one year after leaving our Company. During the past 18 months we have also retained additional employees with expertise in developing, marketing and selling software solutions. In order to successfully market our technology, we will need to retain additional technology 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. 14 WE CAN NOT 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(TM) (Vector Segment Technology), the core algorithm of our biometric identification solution. We can not assure you that any additional 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 can not assume 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. 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 December 31, 2001, 20,519,123 shares of our common stock were reserved for issuance upon exercise or conversion of the following securities: * 9,639,947 upon exercise of outstanding stock options and warrants. * 809,951 shares upon exercise of options available for future grant under our existing option plans. * 1,333,333 shares upon conversion of our non interest convertible debenture due September 30, 2003. * 5,457,226 shares upon conversion of our secured convertible note due September 30, 2003. * 2,857,333 shares or more upon conversion of our outstanding shares of Series B Convertible Preferred Stock. In the event of a decline in the market price of our common stock we would be required to issue an indeterminate number of additional shares upon conversion of these preferred shares. * 421,333 or more shares upon conversion of our 5% convertible debenture due September 30, 2003. In the event of a decline in the market price of our common stock we would be required to issue an indeterminate number of additional shares upon conversion of this debenture. 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. We have filed a registration statement covering the public sale of 16,484,765 of these shares. In addition, The Shaar Fund has agreed to provide an additional $1,080,000 through August, 2002 in incremental monthly advances so long as certain conditions are satisfied. In the event that advances are made, additional secured convertible notes will be issued which will further dilute the ownership interest of our existing shareholders. 15 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 A SUBSTANTIAL NUMBER OF SHARES. We filed a registration statement covering the public sale of 16,484,765 or more shares of our common stock. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares. The Shaar Fund's obligation to provide $1,080,000 in incremental monthly advances through August, 2002 is conditioned upon the average trading price of our common stock exceeding $1.00 per share during the month preceding the advance. To the extent that this influx of shares into the public market or other factors reduce the trading price of our common stock to below $1.00, The Shaar Fund would have no obligation to provide this financing and our ability to raise this necessary financing would be significantly impaired. In the event that advances are made, additional secured convertible notes will be issued. We have agreed to register the public resale of the shares issuable upon conversion of any notes issued which will further increase the number of share available for public sale. OUR OUTSTANDING 5% DEBENTURE AND PREFERRED STOCK ARE CONVERTIBLE INTO SHARES OF COMMON STOCK AT A DISCOUNT TO THE TRADING PRICE AT THE TIME OF CONVERSION. THESE CONVERSION PROVISIONS COULD CAUSE INVESTORS TO SHORT SELL OUR SHARES WHICH MAY ADVERSELY AFFECT THE TRADING PRICE OF OUR COMMON STOCK. Our 5% debenture and preferred stock are convertible into shares of common stock at a per share conversion price equal to the lesser of $.75 or a 22% discount to the average of the closing bid prices of our common stock during the five trading days preceding conversion. As a result of these provisions, in the event the trading price of our common stock declines, we will be required to issue a greater number of shares of common stock upon conversion of the debenture and preferred stock. This could result in the issuance of a substantial number of additional shares resulting in substantial dilution to our existing shareholders. To the extent these factors are viewed negatively by the market, they may provide an incentive for persons to execute short sales of our common stock which could further adversely affect the trading price of our common stock. Since the holders of the 5% debenture and preferred stock receive additional shares upon conversion if the trading price of our common stock declines, they may have an incentive to execute short sales of our common stock. The agreement under which these securities were issued precludes the holder from executing short sales of our common stock except in the connection with a conversion of such securities. 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 16 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 for the purchaser and receive the 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 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. 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. "Business Combination" includes mergers, share exchanges, asset sales, plan or proposal of liquidation or dissolution, recapitalization, issuance and transfers of shares in excess of 5% or more of the Company's shares. "Interested Shareholder" means any person who owns directly or indirectly 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, 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 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 17 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. ITEM 2. DESCRIPTION OF PROPERTY The Company does not own any real estate. The Company conducts its operations from leased premises in Eagan, Minnesota. The Company leases approximately 6,000 square feet of space at 1285 Corporate Center Drive, Suite No. 175 under a five-year lease, which terminates on August 31, 2004 and currently provides for monthly rent of $3,325 which increases ratably over the term of the lease to $3,610. The Company believes that its current facility is adequate for the foreseeable future. ITEM 3. LEGAL PROCEEDINGS The Company is not a party to any material pending legal proceeding nor is it aware of any proceeding contemplated by any governmental authority involving the Company. ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS On February 27, 2002, the Company conducted a special meeting of shareholders to consider two (2) proposals. Proposal number one requested approval of an amendment to the Company's Amended and Restated Articles of Incorporation to increase the number of shares of common stock the Company is authorized to issue from 20,000,000 to 60,000,000. This proposal was approved by the affirmative vote of 7,769,593 shares of common stock with 109,873 shares voting against and 12,200 abstaining. There were 2,291,562 broker non-votes. Proposal number two requested approval of an amendment to the Company's Amended and Restated Articles of Incorporation to change the Company's name from SAC Technologies, Inc. to BIO-key International, Inc. This proposal was approved by the affirmative vote of 10,176,209 shares of common stock with 1,019 shares voting against and 6,000 shares abstaining. There were no broker non-votes. 18 PART II ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS The Company's 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 the Company's 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. 2001: HIGH LOW ---- ---- --- Quarter ended December 31, 2001 $1.07 $.15 Quarter ended September 30, 2001 .25 .13 Quarter ended June 30, 2001 .4375 .18 Quarter ended March 31, 2001 .4375 .2656 2000: HIGH LOW ---- ---- --- Quarter ended December 31, 2000 $1.0625 $.2656 Quarter ended September 30, 2000 1.0469 .50 Quarter ended June 30, 2000 1.0625 .375 Quarter ended March 31, 2000 1.375 .8125 The last price of the Company's common stock as reported on the OTC Bulletin Board on March 20, 2002 was $.79 per share. HOLDERS As of March 19, 2001 the number of stockholders of record of the Company's common stock was 150. 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, the Company believes that there are approximately 1,900 beneficial owners of its common stock. DIVIDENDS The Company has not paid any cash dividends to date, and has no intention of paying any cash dividends on our common stock in the foreseeable future. The declaration and payment of dividends is subject to the discretion of the Company's Board of Directors and to certain limitations imposed under the Minnesota Business Corporation Act. The timing, amount and form of dividends, if any, will depend on, among other things, the Company's results of operations, financial condition, cash requirements and other factors deemed relevant by the Company's Board of Directors. 19 RECENT

SALES OF UNREGISTERED SECURITIES. 1. On November 22, 2001, the Company issued options and warrants to purchase an aggregate of 500,000 shares of common stock at an exercise price of $.3832 per share to certain consultants, including Benjamin Netanyahu, the former Prime Minister of Israel, in consideration of services rendered to the Company, 276,000 of which were issued under the Company's 1996 Option Plan. Under the terms of its agreement with the consultants the Company is obligated to pay additional fees to them based on sales generated as a result of their efforts. At Mr. Netanyahu's option, these fees are convertible into up to 575,000 shares of common stock, at a conversion price of $.3832 provided that such issuance does not cause Mr. Netanyahu to beneficially own in excess of 4.99% of the Company's outstanding common stock. 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. 2. On November 26, 2001, the Company issued a 5% convertible debenture in the principal amount $539,625, a non-interest convertible debenture in the principal amount of $1,000,000, a secured convertible in the principal of $4,092,920, 21,430 shares of Series B Convertible B Preferred Stock and warrants to purchase 4,000,000 shares of common stock to The Shaar Fund Ltd. in consideration of the conversion of $3,567,546 of outstanding indebtedness, conversion of 18,449 shares of Series A Convertible Stock together with all accrued dividends and interest due thereon, and gross cash proceeds of $1,065,000. These securities were issued to one (1) accredited investor 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. 3. Between November 27, 2001 and February 6, 2002, the Company issued an aggregate of 623,050 shares of common stock to The Shaar Fund Ltd. upon conversion of $323,626 principal amount and $175 of accrued interest due under the Company's 5% Convertible Debenture due September 30, 2003. These securities were issued to one (1) accredited investor 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. 4. On December 1, 2001, the Company issued warrants to purchase 27,000 shares of common stock at an exercise price of $1.00 per share to a government relations consultant in consideration of services rendered to the Company. 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. 5. On March 20, 2002, the Company issued warrants to purchase 168,000 and 25,000 shares of common stock at exercise prices of $1.00 and $1.20 per share, respectively, in settlement of a dispute with a former consultant of the Company. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 20 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. ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS AND PLAN OF OPERATION This Management's Discussion and Analysis and Plan of Operation 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 the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements. The Company's 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 1 and elsewhere in this Report. The following should be read in conjunction with the audited financial statements of the Company included elsewhere herein. OVERVIEW Historically, the Company's goal was to develop automated fingerprint identification products which were portable, easily integrated with existing applications and affordable for mass commercialization and distribution through Original Equipment Manufacturers ("OEM"s), distributors and to a lesser degree, system integrators in the computer network, general access control and other markets. This included the development of the proprietary readers. During 1998 and 1999, the evolution of the Company's technology allowed it to shift from providing biometric hardware to developing and licensing biometric identification IT security and identity theft solution software. These solutions are built around the advanced capabilities of the Company's proprietary patent pending VST(TM) (Vector Segment Technology(TM)) algorithm. The Company has pioneered the development of automated, finger identification technology that can be used without the aide of non-automated methods of identification such as a personal identification (PIN), password, token, smart card, ID card, credit card, passport, drivers license or other form of possession based or knowledge based identification. This advanced BIO-key(TM) identification technology improves both the accuracy and speed of finger-based biometrics and is the only finger identification algorithm that has been certified by the International Computer Security Association (ICSA). Over the past two years, recognizing the growth in electronic commerce, private networks and related security concerns, the Company has actively positioned its technology for the licensing of a Web based biometric authentication software solution to e-commerce and other companies conducting business over the Internet. This integrated solution involves the licensing of client and server based software to provide for reliable and cost effective user authentication in connection with the processing of e-commerce transactions or securing access to private networks. 21 The Company has completed the development of its core technology, has commenced the marketing of its technology and expects to generate revenue from licensing arrangements during 2002. Although the Company has developed significant identification technology, it has not gained any meaningful commercial acceptance and the Company has only generated minimal revenue since inception. The Company did not generate any revenue during 2000 or 2001. The Company's business model, particularly the Web authentication initiative, represents a novel approach to Internet and network security which as of the date of this Report has not been adopted by any company conducting business over the Internet. Although recent security concerns relating to the identification of individuals has increased interest in biometrics generally, there can be no assurance that there will be a demand for such a solution or that the Company will have the financial or other resources necessary to successfully market such a software solution. The Company believes its existing financial resources will only last through August 2002. See "LIQUIDITY AND CAPITAL RESOURCES" below. Due to this and other uncertainties, the Company's independent auditors have included an explanatory paragraph in their opinion for the year ended December 31, 2001 as to the substantial doubt about the Company's ability to continue as a going concern. The Company's long-term viability and growth will depend upon the successful commercialization of its technologies and its ability to obtain adequate financing, among other matters, as to which there can be no assurances. PLAN OF OPERATION The following is a description of the Company's Plan of Operation for the next twelve (12) months. BUSINESS STRATEGY The Company's initial goal was to develop automated fingerprint identification products which were portable, easily integrated with existing applications and affordable for mass commercialization and distribution through OEMs, distributors and to a lesser degree, system integrators in the computer network, general access control and other markets. This included the development of readers. During 1998 and 1999 the Company pursued an OEM licensing program and in 2000 and 2001 the Company developed WEB-key(TM), an integrated Web based biometric authentication system. The Company's current business plan consists of a threefold strategy of: 22 * continued development of technology * licensing its core technology (SDK and Web-key) to OEMs, system integrators, Internet service providers and software application developers addressing industry-specific applications * licensing its Web-based biometric authentication software solution to e-commerce and Internet content companies to secure Web based transactions and corporations to secure private networks. Although the Company has developed significant core finger identification software technology, it has not gained any meaningful commercial acceptance, the Company has only generated minimal revenue since inception and it has not entered into any significant licensing arrangements. In addition, the Company's business model, particularly the Web authentication initiative, represents a unique approach to Internet security, requires the distribution and use of additional peripheral hardware, namely an optical reader, and the integration of client and server software. It has not been adopted by any company that conducts business over the Internet. There can be no assurance that there will be a demand for such a solution or that the Company will have the financial, marketing and human resources necessary to successfully market such a software solution. COMPANY PRODUCTS Overview. The Company's primary initiative is the licensing of its Software Developer's Toolkit (SDK) for integration into other applications and WEB-key(TM), it's Web-based, Internet ready three tiered Internet application architecture software security solution. This initiative has involved transitioning the Company's technology to focus on identification applications for large databases and Web based server authentication applications, including porting to multiple platforms and peer group reader technology. These efforts have resulted in the de-coupling of the core identification algorithm from the reader technology providing for the algorithm to be utilized with virtually any reader or scanner. The Company believes that the versatility provided by the de-coupling of the identification algorithm and reader technology will facilitate the pursuit of licensing Web based server authentication applications. Successful execution of this initiative has also required the development of enhanced software to provide an effective interface between client and server-based software. The Company continues to refine this software. VST (Vector Segment Technology), Patent Pending, Systems Developer Kit (SDK). The Company's SDK is a means of delivering its 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 23 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 on the market today, 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 can not. 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(TM). WEB-key(TM) is the Company's Web-based, Internet ready three tiered Internet application architecture software security solution. The Company licenses WEB-key(TM) as an integrated solution of it's 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 simple 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 also intended to secure other Internet applications such as restricting access to specific Web pages, specific information contained on a Web-site or specific applications. The Company believes it has the opportunity to be the first supplier of a reliable electronic identification and authorization solution which operates effectively without the aid of a personal identification number or password supplied by the user. The Company does not currently, and does not intend in the future, to manufacture any hardware. The Company relies on OEMs systems integrators and other licensees of its software to supply the necessary hardware, including optical readers. The Company has relationships with hardware manufacturers which enable the Company to supply readers to potential customers as an integrated solution when necessary. Currently, the Company has integrated its software with readers manufactured by Polaroid, Authentec, Ethentica, Siemens, and other independent manufactures. The Company's technology includes proprietary open architecture communication software which allows virtually any reader to be integrated with the Company's software within several weeks. 24 The Company's SDK and WEB-key software are available for licensing and during 2002, the Company commenced a direct selling effort. During the second quarter of 2002, the Company has entered into license agreements with OEMs and systems integrators and other licensees of its software to develop applications for distribution to their respective customers. The Company expects to continue to generate revenue during the remainder of 2002 from existing and new customer relationships. MARKETING AND DISTRIBUTION The Company's marketing and distribution efforts consist of: * Development of strategic alliances with technology leaders * General promotion of biometric technology and the Company's offerings * Direct technology licensing efforts to, among others, OEMs, application developers and operators of private network. The Company's current marketing efforts are conducted primarily through direct selling efforts of its Chief Executive Officer, President and other marketing personnel to OEMs, application developers and operators of private networks. The Company attends and actively participates in various product conferences and conventions in the technology and security industries to generate market awareness of biometric technology generally and the Company's offerings specifically. In this connection, the Company has made a collaborative presentations with Intel Corporation during the past 2 years. See "BUSINESS OF THE COMPANY - MARKETING AND DISTRIBUTION". The Company has been aggressively marketing its WEB-key and SDK technology to leads generated from these efforts. The Company has also entered into alliances and/or joint sales and marketing arrangements with Oracle, Intel, and Siebel Systems to develop and implement new security systems utilizing the Company's technology for the Federal Government. The events of September 11th have heightened the need for securing data dissemination throughout and between government agencies and automating the positive identification of personnel. The Company believes that its finger identification technology coupled with the capabilities of its alliance partners are the most advanced solutions capable of meeting these needs. The Company is targeting both Internet infrastructure companies and large portal providers as licensees of its WEB-Key solution. On the Internet infrastructure side, the Company is currently seeking to partner with Internet server manufacturers, providers of database and data warehouse engine software, horizontally positioned application engines, firewall solution providers and peripheral equipment manufacturers. On the portal side, the Company is currently targeting financial service providers such as credit and debit card authorization and issuing institutions, Internet retailers, business-to-business application service providers (ASPs) and corporate intranets. For the following reasons, the Company has yet to generate any significant revenue. The Company competes in a new and evolving market and offers a novel software solution. This has resulted in a long sales cycle as commercial markets continue to evaluate biometrics as a viable alternative to more traditional security methods such as personal identification numbers, passwords and the like. In addition, during 2000 and 2001, the Company was focused on developing and refining its technology and introducing its technology 25 to the market through participation in technology conferences and trade shows. The Company did not begin a direct selling effort until 2002. This effort has resulted in the Company generating revenue in the second quarter of 2002. CAPITAL REQUIREMENTS During the past year, the Company has reduced its administrative expenses such that it currently requires approximately $180,000 per month to conduct operations. Based on available cash resources and the existing funding obligations, the Company believes it can maintain operations at current levels for only three additional months (August, 2002). The Company needs approximately $1,800,000 to continue to operate at current levels for the next twelve (12) months. Unless the Company is able to generate in excess of $180,000 of revenue per month, it will be required to raise additional capital to continue operations beyond the short term. See "LIQUIDITY AND CAPITAL RESOURCES" below. RESEARCH AND DEVELOPMENT Although management believes that the Company's identification technology is one of the most advanced and discriminating fingerprint technologies available on the market today, the markets in which the Company competes are characterized by rapid technological change and evolving standards. In order to maintain its position in the market, the Company will continue to upgrade and refine its existing technologies. During the next twelve months, the Company will continue to focus on enhancing its identification technology for large databases, Web based server authentication applications, including porting to multiple platforms, and peer group reader technology. The Company expects successful development of this solution will require additional financing to which there can be no assurance. RESULTS OF OPERATIONS YEAR ENDED DECEMBER 31, 2001 AS COMPARED TO YEAR ENDED DECEMBER 31, 2000: REVENUES The Company had no revenue during 2001 or 2000. This was due to the Company's decision to deploy substantially all human and capital resources to executing its new business plan targeted at licensing biometric identification IT security and identity theft solution software for Internet, intranet and electronic commerce applications. As a result, the Company's limited resources were used to refine its technology to develop the applications needed to execute against this plan. COSTS AND OTHER EXPENSES Selling, general and administrative expenses. Selling, general and administrative expenses decreased $534,402 to $1,318,465 during 2001 as compared to $1,852,867 in 2000. Of the decrease, approximately $117,869 related to a 26 decrease in costs for administrative personnel, approximately $301,126 related to a decrease in costs associated with the services of an administrative consultant, approximately $256,212 related to a decrease in outside professional service charges, approximately $58,909 related to a decrease in general operating costs, and approximately $94,500 related to a decrease in the non-cash accrual of penalties incurred for failing to file a registration statement covering the public sale of common shares issuable upon conversion of the Company's Series A Convertible Preferred Stock. These amounts were offset by an increase of approximately $294,214 in sales and marketing costs associated with the implementation of the Company's revised business plan. In order to preserve its limited resources, the Company has reduced selling, general and administrative expenses from $2,151,466 to $1,318,465 during the past two years. Although the Company continues to closely monitor expenses to reduce overhead, it expects marketing expenses to increase as it continues to focus on generating revenue and does not expect to further materially reduce expenses during 2002. Research and Development. Research, development and engineering expenses decreased $188,308 to $947,932 in 2001 as compared to $1,136,240 in 2000. Of the decrease, approximately $137,500 was due to a decrease in personnel costs and approximately $102,315 was due to a decrease in general operation expenses. These amounts were offset by an increase of approximately $51,507 for services of outside programming sub-contractors. Interest Expense. Interest expense increased $176,286 to $317,627 in 2001 as compared to $141,341 in 2000. The increase was due to an increase in interest accrued on additional short term indebtedness of approximately $1,370,000. NET OPERATING LOSS CARRYFORWARDS As of December 31, 2001, the Company has federal net operating loss carryforwards of approximately $18,155,000. The carryforwards expire between 2008 and 2021. 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. YEAR ENDED DECEMBER 31, 2000 AS COMPARED TO YEAR ENDED DECEMBER 31, 1999: REVENUES The Company did not generate any revenue during the year ended December 31, 2000 resulting in a $157,970 decrease from the year ended December 31, 1999. This decrease was due to the Company's decision to deploy substantially all human and capital resources to executing its new business plan targeted at Internet, intranet and electronic commerce security. As a result, the Company's limited resources were used to refine its technology to develop the applications needed to execute against the Company's revised business plan. COSTS AND OTHER EXPENSES Cost of product sales. The Company had no revenue during 2000 and, therefore, did not incur any cost of product sales. During 1999, the Company incurred cost of sales of $452,593 which was $294,623 in excess of 1999 revenue. As set forth above, during 2000, the Company focused its resources exclusively on the development of its technology. 27 Selling, general and administrative expenses. Selling, general and administrative expenses decreased $298,599 to $1,852,867 during 2000 as compared to $2,151,466 in 1999. Of the decrease, approximately $341,000 related to a decrease in costs for selling and administrative personnel, approximately $360,000 related to a decrease in marketing expenses, approximately $235,000 related to a decrease in outside professional service charges, and approximately $194,000 related to a decrease in general operating costs. These amounts were offset by an increase in the non-cash accrual of penalties incurred for failing to file a registration statement for the Company's Series A Convertible Preferred Stock of approximately $498,000 and approximately $369,000 for costs associated with the services of an administrative consultant, approximately $200,000 of which consisted of non cash accrual of the fair value of options issued in consideration of such services. Research and Development. Research, development and engineering expenses increased $279,553 to $1,136,245 in 2000 as compared to $856,692 in 1999. Of the increase, approximately $70,000 was due to an increase in personnel costs, approximately $170,000 was due to an increase in costs associated with the services of outside programming sub-contractors and the balance was due to general operation expenses associated with increased development activity. Additional Income. The Company did not generate any additional income in 2000 as compared to $208,621 in 1999. Of the decrease, approximately, $190,000 represented proceeds from the sale of the Company's interest in Inter-con P/C, Inc. in 1999 with no comparable transaction in 2000. Interest Expense. Interest Expense decreased $192,856 to $141,341 in 2000 as compared to $334,197 in 1999. Of the decrease, approximately $205,000 related to a decrease in the amortization of the fair market value of warrants issued in financing transactions in 2000 as compared to 1999, $44,000 related to a reduction in interest charges associated with a lower principal balance on the convertible debenture as a result of conversions of such debenture during 1999 and 2000. These amounts were offset by a $57,000 increase in interest accrued on short term indebtedness. LIQUIDITY AND CAPITAL RESOURCES Net cash used in operating activities during 2001 was $1,925,725, and was principally due to operating losses. The operating losses were primarily funded by cash on hand at December 31, 2000 and proceeds from the sale of Company securities and unsecured short term financing. Net cash provided by financing activities in 2001 was $2,394,500, which consisted of the issuance of $1,370,000 principal amount of short term notes to The Shaar Fund Ltd. (the "Fund") between January and November 2001 and $1,024,500 realized from a recapitalization transaction with the Fund on November 26, 2001. 28 Pursuant to the recapitalization transaction, the Company obtained $1,065,000 of additional financing through the issuance of a secured convertible promissory note (the "Secured Note"). All existing promissory notes payable to the Fund together with all accrued and unpaid interest due thereon ($3,027,920) were cancelled and converted into the Secured Note. The Secured Note is due September 30, 2003, is secured by substantially all of the Company's assets, including its intellectual property, accrues interest at the rate of 10% per annum payable quarterly in arrears commencing September 30, 2002, may be prepaid without penalty and is convertible into shares of common stock at a conversion price of $.75 per share. The security interest terminates upon the Company obtaining $5,000,000 of additional equity financing. In this transaction, the Company received net cash proceeds of $1,024,500 after giving effect to offering costs of $40,500. The Fund has agreed to provide up to $1,080,000 of additional financing in incremental monthly installments during the six month period commencing March 1, 2002. Any such funding will be provided pursuant to a secured promissory note on the terms described above. The Fund's obligation to provide this financing is conditioned upon: * The Company being in compliance with all material obligations under the November 26, 2001 funding agreement between the parties, the Secured Note and debentures issued to the Fund pursuant thereto, and the other agreements between the parties. * The continued truth and accuracy of the representations and warranties of the Company set forth in the funding agreement. * The average closing bid price of the Company's common stock during the calendar month preceding the advance exceeding $1.00 per share. Provided the forgoing conditions are satisfied, funds are advanced upon ten (10) business days written notice from the Company which notice shall be delivered not earlier than the first business day of the month of the requested advance. On or about March 15, 2002, the Company requested and received an advance in the amount of $180,000. After the final advance has been made, the Company has agreed to file a registration statement covering the public resale of the shares of common stock issuable upon conversion of the secured promissory notes issued against each advance. Working capital increased $3,761,382 during 2001 to a surplus of $392,533 on December 31, 2001 as compared to a deficit of $3,368,849 on December 31, 2000. This increase is principally due to an increase in cash of approximately $466,000 (primarily from new borrowings less cash used in operations of approximately $1,926,000), a decrease in short-term obligations of approximately $1,999,000 (primarily due to the effects of the recapitalization transaction), a decrease in accounts payable and accrued liabilities of approximately $1,121,000 (primarily due to the effects of the recapitalization transaction), and an increase in prepaid expenses of approximately $185,000. Since January 7, 1993 (date of inception), the Company's capital needs have been principally met through proceeds from the sale of equity and debt securities. 29 The Company does not currently maintain a line of credit or term loan with any commercial bank or other financial institution. As of June 19, 2002, the Company has cash resources of approximately $240,000. Pursuant to its agreement with the Fund, $285,000 of additional financing is available to the Company upon fulfillment of the conditions described above. Although the Fund has, in the past, provided financing to the Company notwithstanding that all of the conditions have not been satisfied, there can be no assurance that it will continue to do so. During the past year, the Company has reduced its administrative expenses such that it currently requires approximately $180,000 per month to conduct operations. Based on available cash resources and the existing funding obligations, the Company believes it can maintain operations at current levels for only three additional months (August, 2002). The Company needs approximately $1,800,000 to continue to operate at current levels for the next twelve (12) months. Ideally, the Company needs approximately $5,000,000 to $7,000,000 to execute its business plan and support the growth of operations through 2003 and to continue product enhancements. The additional financing is required to conduct the sales and marketing effort necessary to engage in significant direct selling and marketing activities. During the second quarter of 2002, the Company has entered into license agreements, begun to generate revenue and believes it will continue to generate revenue from existing and new relationships during the remainder of the year. Anticipated revenues are expected to defray operating expenses and reduce the amount of required additional financing but are not expected to be sufficient for the Company to expand operations. In addition to generating revenue, the Company is seeking to obtain additional financing through the issuance of additional debt or equity securities of the Company on a negotiated private placement basis to institutional and accredited investors. In this connection, in March 2002 the Company retained a financial advisory firm to assist the Company in raising the necessary additional capital. The financial advisory firm continues to conduct its due diligence of the Company and management expects to be introduced to potential funding sources in the coming months. As of June 19, 2002, the Company has not reached any definitive agreement with any potential investor regarding the specific terms of an investment in the Company. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained to meet its needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or unavailable or the Company fails to generate any meaningful revenue, it may be required to further reduce operating expenses, suspend operations, seek a merger or acquisition candidate or ultimately liquidate its assets. ITEM 7. FINANCIAL

STATEMENTS See Financial Statements beginning on page F-1. 30 PART III ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT The following sets forth certain information about each director and executive officer of the Company. --------------------------- ----------- -- NAME AGE POSITIONS HELD ---- --- ------------- --------------------------- ----------- -- --------------------------- ----------- -- Jeffry R. Brown 53 Chief Executive Office and Chairman of the Board of Directors --------------------------- ----------- -- H. Donald Rosacker, II 40 President, Director --------------------------- ----------- -- Gary E. Wendt 60 Chief Financial Officer, Secretary and Director --------------------------- ----------- -- Jeffrey J. May 41 Director --------------------------- ----------- -- Mira K. LaCous 40 Vice President of Technology --------------------------- ----------- -- The following is a brief summary of the business experience of each of the above-named individuals: JEFFRY R. BROWN has served as Director of the Company since September 1999, as President of the Company from November 13, 2000 to July 1, 2001 and as Chief Executive Officer since July 1, 2001. Between 1999 and July 2000, Mr. Brown served as managing director for Chancellor Media Group, a division of AmFm Media. From 1995 to 1999, Mr. Brown served as a marketing, promotion and sponsorship consultant for such clients as Signature Sports, Born Information Services and the JC Penney Company. As Senior Vice President Business Development for Gage Marketing Group, LLC between 1992 and 1995, Mr. Brown represented clients such as Proctor and Gamble, Paramount, RJ Reynolds, and Frito Lay. H. DONALD ROSACKER, II has served as the President and a Director of the Company since August 1, 2001. Mr. Rosacker has primary responsibility for the operations, sales and marketing functions of the Company. Between 1994 and 2000, Mr. Rosacker served as the President and Chief Executive Officer of Tekmerchant.com/FlowersandGifts.com, a Minneapolis, Minnesota based e-commerce company, where he managed the restructure of that company from a business-to-consumer Internet company to a business-to-business technology development company. Between 1992 and 1994, Mr. Rosacker served as President of Mantech Corporation, a Minneapolis, Minnesota based software developer where he managed the launch of advanced technology applications for the manufacturing industry. Mr. Rosacker has in excess of 15 years of financial and marketing management experience in start-up and emerging growth companies. Mr. Rosacker earned a Bachelors degree in Computer Science from the University of Minnesota in 1983. GARY E. WENDT has served as the Chief Financial Officer and a Director of the Company since its inception in 1993. Mr. Wendt has primary responsibility for the Company's financial reports and administers accounting operations. From 1993 to 1994, Mr. Wendt was Treasurer and Chief Financial Officer of Esprit Technologies, Inc., a computer manufacturer which produced high speed PCs marketed primarily to government and industry in the Midwestern United States. Mr. Wendt attended Metropolitan State University, North Hennepin Community College, and the Academy of Accountancy where he was certified in public accounting. Mr. Wendt is not a Certified Public Accountant. 31 JEFFREY J. MAY has served as a Director of the Company since October 29, 2001. Since 1997, Mr. May has served as the President of Gideons Point Capital, a Tonka Bay Minnesota based financial consulting firm and angel investor focusing on assisting and investing in start-up technology companies. In 1983, Mr. May co-founded Advantek, Inc., a manufacturer of equipment and materials which facilitate the automatic handling of semi-conductors and other electrical components which was sold in 1993. Mr. May continued to serve as a director and Vice-President of Operations of Advantek until 1997, at which time 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. MIRA K. LACOUS has served as Vice President of Technology and Development of the Company since May 15, 2000. On November 20, 2001, Ms. LaCous was appointed to serve as an executive officer of the Company. Ms. LaCous has primary responsibility for all engineering and software development functions of the Company. Ms. LaCous has over 15 years computer software design experience in the areas of Voice Automation, Commercial Building Control, Information Scanning and Internet Systems, and Internet Security Training. From 1997 until joining the Company, she was employed by National Computer Systems, Inc. as Director Software Development. Between 1997 and March 2000, Ms. LaCous acted as an independent consultant serving such clients as TEL-line Systems and Security Analysts. From 1989 to 1997 Ms. LaCous served as a Senior Project Manager with The Trane Company. Ms. LaCous earned a Bachelors degree in Computer Science for North Dakota State University. DIRECTORS' TERMS OF OFFICE Gary Wendt was elected as a director at the Company's 1998 Annual Meeting of Shareholders to hold office for a term of one (1) year until his successor is duly elected and qualified. Jeffry R. Brown, H. Donald Rosacker, II and Jeffrey J. May were appointed by the Board of Directors to fill vacancies created by the resignations or death of directors and to serve until the next annual meeting of shareholders until their successors are duly elected and qualified. BOARD OF DIRECTORS All directors hold office until the next annual meeting of shareholders and the election and qualification of their successors. Officers are elected annually by the Board of Directors and serve at the discretion of the Board. ADVISOR TO BOARD OF DIRECTORS On November 22, 2001, the Company retained Benjamin Netanyahu, the former Prime Minister of Israel, to serve as a senior strategy advisor to the Board of Directors for a term of ten (10) months. During the term, Mr. Netanyahu is prohibited from consulting with other companies in the biometric identification market. DIRECTORS COMPENSATION Directors who are also officers of the Company receive no additional compensation for serving on the Board of Directors, other than reimbursement of reasonable expenses incurred in attending meetings. The Company's 1996 stock 32 incentive plan provides for the grant of options to purchase 50,000 shares of common stock to each non-employee director upon first being elected or appointed to the Board of Directors. 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, 2001, all Section 16(a) filing requirements applicable to the Company's officers, directors and ten percent (10%) stockholders were satisfied in a timely fashion except that Mira LaCous did not timely file a Form 3 upon being appointed to serve as an executive officer of the Company. 33 ITEM 10. EXECUTIVE COMPENSATION The following table provides certain summary information concerning compensation paid to or accrued by the Company's Chief Executive Officer, and all other executive officers of the Company during the fiscal years ended December 31, 1999, 2000 and 2001: SUMMARY COMPENSATION TABLE NAME AND PRINCIPAL FISCAL SECURITIES UNDERLYING POSITION YEAR SALARY($) BONUS($) OPTIONS (#) -------- ---- --------- -------- ----------- Jeffry R. Brown, (1) 2001 144,000 -- 400,000 Chief Executive Officer 2000 18,000 -- 580,000 H. Donald Rosacker, II, (2) 2001 45,400 -- 400,000 President Gary E. Wendt, 2001 92,427 -- -- Chief Financial Officer 2000 89,039 -- -- 1999 100,274 -- 97,000 Mira LaCous, (3) 2001 99,984 340,000 Vice President of 2000 61,657 15,000 100,000 Technology and Development Barry M. Wendt, (4) 2001 119,463 -- -- Former Chief Executive 2000 112,926 -- -- Officer 1999 128,440 -- -- (1) Mr. Brown served as President of the Company from November 13, 2000 until July 1, 2001. Mr. Brown has served as the Chief Executive Officer of the Company since July 1, 2001. (2) Mr. Rosacker has served as President of the Company since August 1, 2001. (3) Ms. LaCous has served as Vice President of Technology and Development of the Company since May 15, 2000 (4) Barry M. Wendt resigned as Chief Executive Officer of the Company on July 1, 2001 and as Chairman of the Board of Directors on December 8, 2001. Includes $63,000 paid pursuant to a consulting agreement which terminated January 31, 2002. 34 OPTION GRANTS IN YEAR ENDED DECEMBER 31, 2001 (Individual Grants) The following table sets forth for the named executive officer information regarding stock options granted to such officer during the 2001 fiscal year. == INDIVIDUAL GRANTS ------------------------- ------------- --------------- ---------------- ------------------- % OF TOTAL OPTIONS GRANTED TO EXERCISE OR OPTIONS EMPLOYEES IN BASE PRICE EXPIRATION NAME GRANTED (#) FISCAL YEAR ($/Sh) DATE ------------------------- ------------- --------------- ---------------- ------------------- Jeffry R. Brown 400,000(1) 31.25 .20 June 30, 2008 ------------------------- ------------- --------------- ---------------- ------------------- H. Donald Rosacker, II 400,000(2) 31.25 .20 July 31, 2008 ------------------------- ------------- --------------- ---------------- ------------------- Mira LaCous 340,000(3) 26.56 .46 November 19, 2008 ========================= ============= =============== ================ =================== (1) Options to purchase 200,000 shares vested upon issuance with the remainder vesting in equal monthly installments over a one year period. (2) Options to purchase 60,000 shares vested upon Mr. Rosacker completing 90 days of employment with the Company (the "Initial Vesting Date") with the remainder vesting in equal monthly installments over a three year period commencing on the Initial Vesting Date. Options to purchase 300,000 shares were issued under the Company's 1999 Stock Option Plan. (3) Options to purchase 75,000 shares vested upon issuance with the remainder vesting in equal monthly installments over a three year period commencing on the date of grant. Options to purchase 200,000 shares were issued under the Company's 1999 Stock Option Plan. 35 AGGREGATED OPTION EXERCISES IN THE 2001 FISCAL YEAR AND FISCAL YEAR-END OPTION VALUE The following table sets forth for each named executive officer, information regarding stock options exercised by such officer during the 2001 fiscal year, together with the number and value of stock options held at 2001 fiscal year-end, each on an aggregated basis. == INDIVIDUAL GRANTS ------------------------------ ------------------ -------------- -------------------- ---------------------- NUMBER OF VALUE OF UNEXERCISED UNEXERCISED OPTIONS IN-THE-MONEY OPTIONS NUMBER OF SHARES AT FISCAL YEAR-END AT FISCAL YEAR-END ACQUIRED ON EXERCISABLE/ EXERCISABLE/ NAME EXERCISE VALUE REALIZED UNEXERCISABLE(#) UNEXERCISABLE($) (1) ------------------------------ ------------------ -------------- -------------------- ---------------------- Jeffry R. Brown -- -- 716,667/313,333 314,198/117,000 ------------------------------ ------------------ -------------- -------------------- ---------------------- Gary E. Wendt -- -- 144,280/29,100 5,601/1,746 ------------------------------ ------------------ -------------- -------------------- ---------------------- H. Donald Rosacker, II -- -- 88,332/311,668 64,482/227,518 ------------------------------ ------------------ -------------- -------------------- ---------------------- Mira LaCous -- -- 157,361/282,639 56,709/127,086 ============================== ================== ============== ==================== ====================== (1) The last sales price of the Company's Common Stock as reported on the OTC Bulletin Board on December 31, 2001 was $.93. EMPLOYMENT AGREEMENTS JEFFRY R. BROWN. On November 13, 2000, the Company entered into two-year (the "Initial Term") employment agreement with Jeffry R. Brown to serve as the President of the Company at an annual base salary of $144,000, and an annual bonus payable at the discretion of the Board of Directors. In recognition of the nearly full time attention Mr. Brown provided to the Company as a non employee director, the agreement also provided for a $24,000 signing bonus. The employment agreement will be renewed automatically for successive one year periods unless the Company provides written notice of non-renewal at least three months prior to the date employment would otherwise terminate. 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. Brown 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. The agreement may be terminated by the Company at any time with or without cause. In the event of termination without cause, Mr. Brown shall continue to be paid his then current base salary for a period of nine months from the date of such termination; and if the termination occurs during the Initial Term, options to purchase the lesser of (A) one hundred fifty thousand and three (150,003) shares of common stock; and (B) the number of shares of common stock issuable upon the exercise of the remaining unvested options shall vest immediately upon termination. Mr. Brown may terminate the employment 36 agreement if his current salary or benefits are reduced by more than 30%, in which event Mr. Brown will continue to be paid his then current base salary for a period of nine months from the date of such termination. H. DONALD ROSACKER. On August 1, 2001, the Company entered into a one year employment agreement with Mr. Rosacker to serve as the President of the Company at an annual base salary of $108,000 and a bonus of up to 50% of his base salary payable at the discretion of the Board of Directors. The agreement automatically renews for an additional one year term unless written notice of termination is received at least one month prior to the date it would otherwise terminate. The 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. Rosacker 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. The agreement may be terminated by the Company at any time with or without cause. In the event Mr. Rosacker is terminated without cause after completing nine months of employment with the Company, Mr. Rosacker shall continue to be paid his then current base salary for a period of nine months from the date of such termination. Mr. Rosacker may terminate the agreement if his current salary or benefits are reduced by more than 30%, in which event Mr. Rosacker shall continue to be paid his then current base salary for a period of two months from the date of such termination. GARY E. WENDT. On May 10, 1996, the Company entered into a five-year employment agreement with Gary E. Wendt to serve as the Chief Financial Officer of the Company. The employment agreement was renewed for a one year term and renews from year to year for consecutive one year terms unless written notice of termination is received at least six months prior to the end of the renewal term. The agreement provides for a base salary subject to an annual increase by the Board of Directors and a bonus payable at the discretion of the Board of Directors. Under the agreement, Mr. Wendt may be terminated only for "cause" as that term is defined in the employment agreement. The employment agreement contains standard and customary confidentiality, "work made for hire" and non-solicitation provisions and incorporates a Non-Competition Letter entered into in connection with his employment. The Non-Competition Letter prohibits Mr. Wendt from competing with the Company for a period of three years if the Company terminates employment for cause and a period of two years if Mr. Wendt voluntarily terminates employment. In the event of a termination without cause, or a "constructive termination", which is defined to include an adverse change in Mr. Wendt's status or position in the Company, a reduction of his base salary other than for austerity purposes, or breach by the Company of any of its other contractual obligations for other than austerity reasons, Mr. Wendt's non-competition obligations lapse and he will receive severance in an amount equal to his base salary for two years. MIRA LACOUS. On November 20, 2001, the Company entered into a one year employment agreement with Mira LaCous to serve as the Vice President of Technology and Development of the Company at an annual base salary of $100,000 and a bonus of up to 50% of her base salary payable at the discretion of the Board of Directors. Ms. LaCous has been employed by the Company since May 15, 37 2000. The agreement automatically renews for an additional one year term unless written notice of termination is received at least one month prior to the date it would otherwise terminate. The agreement contains standard and customary confidentiality, non-solicitation and "work made for hire" 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. The agreement may be terminated by the Company at any time with or without cause. In the event Ms. LaCous is terminated without cause after completing one year of employment with the Company, Ms. LaCous shall continue to be paid her then current base salary for a period of nine (9) months from the date of such termination. Ms. LaCous may terminate the agreement if her current salary or benefits are reduced by more than 30%, in which event Ms. LaCous shall continue to be paid her then current base salary for a period of two months from the date of such termination. CHANGE IN CONTROL PROVISIONS The Company's 1996 Stock Option Plan (as amended to date, the "1996 Plan") and 1999 Stock Option Plan (the "1999 Plan" and together with the 1996 Plan, the "Plans")) provide for the acceleration of the vesting of unvested options upon a "Change in Control" of the Company. A Change in Control is defined in the Plans 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. In the event of a "Change In Control" both Plans provide for the immediate vesting of all options issued thereunder. The 1999 Plan provides for the Company 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 all options issued under the 1999 Plan may be exercised. Thereafter, all options issued under the 1999 Plan automatically expire. The 1996 Plan provides for all options to remain exercisable for the remainder of their respective terms and permits the Company to make a cash payment to the any or all optionees in respect of any or all options equal to the difference between the exercise price of such option and the fair market value of the Company's Common Stock immediately prior to the Change In Control. Options issued to executive officers outside of the Plans contain change in control provisions substantially similar to those contained in the 1999 Plan. 38 ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT The following table sets forth, as of March 20, 2002, 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. AMOUNT AND NATURE OF BENEFICIAL PERCENTAGE

NAME AND ADDRESS OF BENEFICIAL OWNER OWNERSHIP(1) OF CLASS(1) --- ----------- Jeffry R. Brown 883,332(2) 6.5% 1285 Corporate Center Drive Suite No. 175 Eagan, MN 55121 Gary E. Wendt 556,555(3) 4.3% 1285 Corporate Center Drive Suite No. 175 Eagan, MN 55121 H. Donald Rosacker II 123,886(4) * 1285 Corporate Center Drive Suite No. 175 Eagan, MN 55121 Jeffrey J. May 75,000(5) * 1285 Corporate Center Drive Suite No. 175 Eagan, MN 55121 Mira LaCous 219,166(6) 1.7% 1285 Corporate Center Drive Suite No. 175 Eagan, MN 55121 Barry M. Wendt 960,800 7.6% c/o SAC Technologies, Inc. 1285 Corporate Center Drive Suite No. 175 Eagan, MN 55121 39 Richard T. Fiskum 1,237,500 9.8% 28690 660th Avenue Litchfield, MN 55355 N. Deanne Wittig and Richfield Bank & Trust Co., 1,237,500 9.8% Co-Trustees under the Will dated October 23, 1998, The Qualified Property Marital Trust II (7) 10264 Scarborough Circle Bloomington, MN 55437 All officers and directors as a group 1,857,939 13.1% (5) persons -------------------- *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 12,685,209 shares of common stock outstanding as of March 20, 2002. (2) Consists of shares issuable upon exercise of options. Does not include 146,668 shares issuable upon exercise of options subject to vesting. (3) Includes 151,555 shares issuable upon exercise of options. Does not include 21,825 shares issuable upon exercise of options subject to vesting. (4) Consists of shares issuable upon exercise of options. Does not include 276,114 shares issuable upon exercise of options subject to vesting. (5) Consists of shares issuable upon exercise of options. Does not include 125,000 shares issuable upon exercise of options subject to vesting. (6) Consists of shares issuable upon exercise of options. Does not include 220,834 shares issuable upon exercise of options subject to vesting. (7) The voting and disposition of these shares are controlled by N. Dean Wittig and officers of Richfield Bank and Trust Co., as trustees. 40 ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS EMPLOYMENT ARRANGEMENTS The Company has employment agreements with each of Jeffry R. Brown, H. Donald Rosacker II, Gary Wendt and Mira LaCous. Since Messrs Brown, Rosacker and Wendt comprise a majority of the Company's Board of Directors, they determine their own salaries and bonuses. During the past three fiscal years, with the exception of a signing bonus to Ms. LaCous, the Company has not paid any bonuses or increased the compensation of any of its executive officers. See "EXECUTIVE COMPENSATION - EMPLOYMENT AGREEMENTS." See "EXECUTIVE COMPENSATION - EMPLOYMENT AGREEMENTS." OPTIONS GRANTED TO EXECUTIVE OFFICERS AND DIRECTORS During 2000 and 2001, the Company granted non-qualified stock options to purchase an aggregate of 2,160,000 shares of common stock to its executive officers, 1,240,000 of which were issued under the Company's 1999 Stock Incentive Plan. During 2001, the Company issued options to purchase 200,000 shares of common stock to Jeffrey J. May upon his appointment as a director of the Company. All options were issued at exercise prices equal to the last sales price of the Company's common stock as reported on the OTC Bulletin Board on the date of grant, have terms of seven (7) years, and vest over a one to three year period. SURRENDER OF OPTIONS On April 7, 2000 Barry M. Wendt surrendered options to purchase 218,920 shares of Common Stock and Benedict A. Wittig surrendered options to purchase 188,690 shares of Common Stock. Upon surrender, these options were cancelled by the Company. CONSULTING AGREEMENT WITH BARRY WENDT In connection with Barry Wendt's resignation as the Chief Executive Officer of the Company on July 1, 2001, the Company and Barry Wendt entered into a consulting agreement pursuant to which Mr. Wendt served as a technology advisor to the Company until January 31, 2002. Under the Consulting Agreement, the Company paid consulting fees of $63,000 to Barry Wendt and reimbursed him for out-of-pocket expenses in consideration of approximately 100 hours of services per month. These services consisted of working with the Company's VP of Technology and Development on writing and defining certain technologies related to the Company's Vector Segment Technology and other technology originally developed by the Company. As a co-founder of the Company, Barry Wendt was the principal engineer involved in the design and development of the Company's core technology between 1993 and 2000. The fees paid to Barry Wendt were the result of negotiation after considering his unique knowledge and expertise of the Company's technology and on a per hour basis, were approximately equal to the consulting services obtained by the Company from non-affiliated third parties over the past two years. 41 ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K (a) The following documents are filed as part of this Report. Portions of Item 13 are submitted as separate sections of this Report: (1) Financial statements filed as part of this Report: Report of Independent Certified Public Accountants Balance Sheets at December 31, 2000 and 2001 Statement of Operations - Years ended December 31, 1999, 2000 and 2001 and January 7, 1993 (date of inception) through December 31, 2001 Statement of Shareholders' Deficit - Years ended December 31, 1999, 2000 and 2001 and January 7, 1993 (date of inception) through December 31, 2001 Statements of Cash Flows - Years ended December 31, 1999, 2000 and 2001 and January 7, 1993 (date of inception) through December 31, 2001 Notes to Financial Statements - December 31, 1999, 2000 and 2001 (2) The following exhibits are filed as part of this Report: -------------------- --- --- Exhibit No. Exhibit Method of Filing -------------------- -- --- 3.1 Amended and Restated Articles of Incorporated by reference to Exhibit 3.1 to Incorporation the Registrant's Registration Statement on SB-2, File No. 333-16451 filed February 14, 1997 (the "Registration Statement") -------------------- -- --- 3.2 Amended and Restated Bylaws Incorporated by reference to Exhibit 3.2 to the Registration Statement -------------------- -- --- 3.3 Certificate of Amendment to Amended and Incorporated by reference to Exhibit 3.3 to Restated Articles of Incorporation the Registrant's Report on Form 10-QSB for the quarter ended March 31, 1999 -------------------- -- --- 3.4 Certificate of Designation of Series A 9% Incorporated by reference to Exhibit 3.4 to Convertible Preferred Stock the Registrant's Current Report on Form 8-K dated July 8, 1999 -------------------- -- --- 3.5 Amended and Restated Certificate of Incorporated by reference to Exhibit 3.5 to Designation of Series A 9% Convertible the Registrant's Annual Report on Form 10-KSB Preferred Stock for the fiscal year ended December 31, 1999 (the "1999 10-KSB") -------------------- -- --- 3.6 Certificate of Designation of Series B 9% Incorporated by reference to Exhibit 3.6 to Convertible Preferred Stock the Registrants Current Report on Form 8-K dated November 26, 2001 (the "November 20, 2001 8-K") -------------------- -- --- 42 -------------------- -- --- 3.7 Amendment to the Amended and Restated Incorporated by reference to Exhibit 3.7 to Articles of Incorporation filed February the Registrant's Registration Statement on 28, 2002 Form SB-2 filed March 27, 2002 -------------------- -- --- 4.1 Specimen of Common Stock Certificate Incorporated by reference to Exhibit 4.1 to the Registration Statement -------------------- -- --- 10.1 SAC Technologies, Inc. 1996 Stock Option Incorporated by reference to Exhibit 10.1 to Plan the Registration Statement -------------------- -- --- 10.2 Employment Agreement by and between Gary Incorporated by reference to Exhibit 10.5 to E. Wendt and the Company dated as of May the Registration Statement 10, 1996 (with Non-Competition Letter effective May 10, 1996 Attached as Exhibit A) -------------------- -- --- 10.3 Amendment No. 1 to the SAC Technologies, Incorporated by reference to Exhibit 10.23 to Inc. 1996 Stock Option Plan the 1999 10-KSB -------------------- -- --- 10.4 SAC Technologies, Inc. 1999 Stock Option Incorporated by reference to Exhibit 10.24 to Plan the 1999 10-KSB -------------------- -- --- 10.5 Employment Agreement dated November 3, Incorporated by reference to Exhibit 10.25 to 2000 by and between the Registrant and the Registrant's Quarterly Report on Form Jeffry R. Brown 10-QSB for quarter ended September 30, 2000 (the "September 30, 2000 10-QSB") -------------------- -- --- 10.6 Option to Purchase 280,000 shares of Incorporated by reference to Exhibit 10.26 to Common Stock issued to Jeffry R. Brown the September 30, 2000 10-QSB -------------------- -- --- 10.7 Non-Qualified Stock Option Agreement Under Incorporated by reference to Exhibit 10.27 to the Registrant's 1999 Stock Option Plan to the September 30, 2000 10-QSB purchase 300,000 shares of Common Stock issued to Jeffry Brown -------------------- -- --- 10.8 Consulting Agreement dated July 1, 2001 by Incorporated by reference to Exhibit 10.28 to and between the Registrant and Barry M. the June 30, 2001

10-QSB Wendt ------------------- --- -- 10.9 Option to purchase 400,000 shares of Incorporated by reference to Exhibit 10.29 to common stock issued to Jeffrey R. Brown the June 30, 2001 10-QSB ------------------- ---
-- 10.10 Employment Agreement dated August 1, 2001 Incorporated by reference to Exhibit 10.30 to by and between the Registrant and H. the June 30, 2001 10-QSB Donald Rosacker II ------------------- --- -- 10.11 Funding Agreement by and between the Incorporated by reference to Exhibit 10.31 to Registrant and The Shaar Fund dated the November 20, 2001 8-K November 26, 2001 ------------------- ---
-- 10.12 Registration Rights Agreement by and Incorporated by reference to Exhibit 10.32 to between The Shaar Fund dated November 26, the November 20, 2001 8-K 2001 -------------------
--- -- 43 -------------------
--- -- 10.13 Exchange Agreement by and between the Incorporated by reference to Exhibit 10.33 to Registrant and The Shaar Fund dated the November 20, 2001 8-K November 26, 2001 ------------------- ---
-- 10.14 Secured Note Due September 30, 2003 Incorporated by reference to Exhibit 10.34 to the November 20, 2001 8-K ------------------- ---
-- 10.15 Restated 5% Convertible Debenture Due Incorporated by reference to Exhibit 10.35 to September 30, 2003 the November 20, 2001 8-K -------------------
--- -- 10.16 No Interest Debenture Due September 30, Incorporated by reference to Exhibit 10.36 to 2003 the November 20, 2001 8-K -------------------
--- -- 10.17 Warrant Incorporated by reference to Exhibit 10.37 to the November 20, 2001 8-K ------------------- ---
-- 10.18 Security Interest Provisions Incorporated by reference to Exhibit 10.38 to the November 20, 2001 8-K ------------------- ---
-- 10.19 Employment Agreement by and between the Incorporated by reference to Exhibit 10.39 to Registrant and Mira LaCous dated November the November 20, 2001 8-K 20, 2001 ------------------- --- -- 10.20 Option to Purchase 140,000 Shares of Incorporated by reference to Exhibit 10.40 to Common Stock issued to Mira LaCous the November 20, 2001 8-K ------------------- --- -- 23.1 Consent of Divine, Scherzer & Brody, Ltd. Filed herewith ------------------- ---
-- 25.1 Power of Attorney (included in the Filed herewith signature page to the Registration Statement) ------------------- --- --
(b) Reports on Form 8-K. On January 22, 2002 the Company filed a Form 8-K dated November 20, 2001 reporting Item 5 Other Events. 44 SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this amendment to the report to be signed on its behalf by the undersigned, thereunto duly authorized. BIO-KEY INTERNATIONAL, INC. Date: June 18, 2002 /s/ Jeffry R. Brown ------------------ Jeffry R. Brown, CHAIRMAN AND CHIEF EXECUTIVE OFFICER Pursuant to the requirements of the Securities Exchange Act of 1934, this amendment to the report has been signed below by the following persons on behalf of the Registrant and in the capacities on the dates indicated. Signature Title Date /s/ H. Donald Rosacker, II President, Director June 18, 2002 -------------------------- H. Donald Rosacker, II /s/ Gary E. Wendt Chief Financial Officer, June 18, 2002 -------------------------- Principal Accounting Officer Gary E. Wendt /s/ Jeffrey J. May Director June 18, 2002 -------------------------- Jeffrey J. May 45 EXHIBIT INDEX EXHIBIT NUMBER DESCRIPTION 23.1 Consent of Divine, Scherzer & Brody, Ltd. 25.1 Power of Attorney (included in the signature page to the Report) 46 ITEM 7 - FINANCIAL STATEMENTS The following financial statements of BIO-key International, Inc. (formerly SAC Technologies, Inc.) are included herein at the indicated page numbers: Page No. -------- Report of Independent Certified Public Accountants F-2 Balance Sheets at December 31, 2000 and 2001 F-3 Statements of Operations - Years ended December 31, 1999, 2000 and 2001, and January 7, 1993 (date of inception) through December 31, 2001 F-4 Statement of Stockholders' Deficit - Years ended December 31, 1999, 2000 and 2001, and January 7, 1993 (date of inception) through December 31, 2001 F-5 Statements of Cash Flows - Years ended December 31, 1999, 2000 and 2001, and January 7, 1993 (date of inception) through December 31, 2001 F-6 Notes to the Financial Statements - December 31, 1999, 2000 and 2001 F-7 F-1 Report of Independent Certified Public Accountants Board of Directors

and Stockholders BIO-key International, Inc. We have audited the accompanying balance sheets of BIO-key International, Inc., formerly SAC Technologies, Inc. (a Minnesota corporation in the development stage) as of December 31, 2000 and 2001 and the related statements of operations, stockholders' deficit and cash flows for each of the three years in the period ended December 31, 2001, and the period January 7, 1993 (date of inception) through December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of BIO-key International, Inc. as of December 31, 2000 and 2001, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, and the period January 7, 1993 (date of inception) through December 31, 2001 in conformity with accounting principles generally accepted in the United States. The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which contemplate continuation of the Company as a going concern. However, as discussed in Note A to the financial statements, the Company is in the development stage and has not generated significant revenues since inception, has suffered recurring losses from operations and has a stockholders' deficit. These aforementioned issues, among others, raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments that might result from this uncertainty. Management's plans in regard to these matters are also discussed in Note A. /s/ Divine, Scherzer & Brody, Ltd. Minneapolis, Minnesota February 28, 2002 F-2 BIO-key International, Inc. (a Corporation in the Development Stage) BALANCE SHEETS ASSETS December 31, ---------------------------- 2000 2001 ------------ ------------ CURRENT ASSETS Cash and cash equivalents $ 48,830 $ 514,970 Accounts receivable 9,118 -- Prepaid expenses 21,745 206,634 ------------ ------------ Total current assets 79,693 721,604 EQUIPMENT, FURNITURE AND FIXTURES, less accumulated depreciation 31,942 -- OTHER ASSETS 50,595 41,706 ------------ ------------ $ 162,230 $ 763,310 ============ ============ LIABILITIES AND STOCKHOLDERS' DEFICIT CURRENT LIABILITIES Notes payable $ 1,400,000 $ -- Convertible debentures 598,455 -- Accounts payable 328,398 238,496 Accrued liabilities 1,121,689 90,575 ------------ ------------ Total current liabilities 3,448,542 329,071 LONG-TERM OBLIGATIONS, net of discount -- 4,331,238 COMMITMENTS AND CONTINGENCIES STOCKHOLDERS' DEFICIT Preferred stock - authorized, 5,000,000 shares of $.01 par value (liquidation preference of $100 per share): Series A 9% Convertible; issued and outstanding, 19,875 as of December 31, 2000 199 -- Series B 9% Convertible; issued and outstanding, 21,430 shares as of December 31, 2001 -- 214 Common stock - authorized, 20,000,000 shares of $.01 par value; issued and outstanding, 9,966,724 and 12,528,469 shares, respectively 99,667 125,285 Additional contributed capital 13,133,600 15,538,025 Deficit accumulated during the development stage (16,519,778) (19,560,523) ------------ ------------ (3,286,312) (3,896,999) ------------ ------------ $ 162,230 $ 763,310 ============ ============ The accompanying notes are an integral part of these statements. F-3 BIO-key International, Inc. (a Corporation in the Development Stage) STATEMENTS OF OPERATIONS January 7, 1993 (date of inception) Years ended December 31, through -- December 31, 1999 2000 2001 2001 ------------ ------------ ------------ ------------ Revenues Product sales $ 57,970 $ -- $ -- $ 577,384 License fees 100,000 -- -- 100,000 Reimbursed research and development -- -- -- 284,506 Technical support and other services -- -- -- 429,885 ------------ ------------ ------------ ------------ 157,970 -- -- 1,391,775 Costs and other expenses Cost of product sales 452,593 -- -- 1,736,895 Cost of technical support and other services -- -- -- 237,317 Selling, general and administrative 2,151,466 1,852,867 1,318,465 11,431,134 Research, development and engineering 856,692 1,136,245 947,932 5,806,125 ------------ ------------ ------------ ------------ 3,460,751 2,989,112 2,266,397 19,211,471 ------------ ------------ ------------ ------------ Operating loss (3,302,781) (2,989,112) (2,266,397) (17,819,696) Other income (deductions) Interest expense (334,197) (141,341) (317,627) (1,329,145) Sundry 208,621 -- -- 509,136 ------------ ------------ ------------ ------------ (125,576) (141,341) (317,627) (820,009) ------------ ------------ ------------ ------------ Loss before extraordinary gain (3,428,357) (3,130,453) (2,584,024) (18,639,705) Extraordinary gain - troubled payable reduction -- -- 300,250 300,250 ------------ ------------ ------------ ------------ NET LOSS $ (3,428,357) $ (3,130,453) $ (2,283,774)

$(18,339,455) ============ ============ ============ ============ Net loss $ (3,428,357) $ (3,130,453) $ (2,283,774) $(18,339,455) Series A 9% convertible preferred stock dividend and accretion (341,600) (307,225) (550,478) (1,199,303) ------------ ------------ ------------ ------------ Loss applicable to common stockholders $ (3,769,957) $ (3,437,678) $ (2,834,252) $(19,538,758) ============ ============ ============ ============ Basic and diluted loss per share Net loss before extraordinary gain $ (.41) $ (.33) $ (.24) $ (2.72) Extraordinary gain -- -- .03 .04 ------------ ------------ ------------ ------------ Net loss (.41) (.33) (.21) (2.68) Convertible preferred stock dividend and accretion (.04) (.03) (.05) (.18) ------------ ------------ ------------ ------------ Loss applicable per common share $ (.45) $ (.36) $ (.26) $ (2.86) ============ ============ ============ ============ Weighted average number of shares used 8,308,093 9,589,304 10,928,311 6,832,110 ============ ============ ============ ============ The accompanying notes are an integral part of these statements. F-4 BIO-key International, Inc. (a Corporation in the Development Stage) STATEMENT OF STOCKHOLDERS' DEFICIT Series A 9% Convertible Series B 9% Convertible Preferred Stock Preferred Stock ----------------------------- ----------------------------- Shares Amount Shares Amount ------------ ------------ ------------ ------------ Sale of common stock January 7, 1993 -- $ -- -- $ -- Sale of common stock January 7, 1993 at $.02 per share -- -- -- -- Redemption of director and officers common stock August 4, 1995 at $0 per share -- -- -- -- Sales of common stock August 4, 1995 through December 22, 1995 at $.17 through $.24 per share -- -- -- -- Redemption of common stock August 4, 1995 through December 22, 1995 at $.22 through $.24 per share -- -- -- -- Issuance of detachable warrants on May 17, 1996, in connection with bridge financing arrangements, valued at $25,000, to purchase 100,000 shares of common stock at $1.00 per share -- -- -- -- Sales of common stock during June and July, 1996 at $1.00 per share, less offering costs of $124,663 -- -- -- -- Conversion of bridge notes plus accrued interest of $1,841 to common stock on June 28, 1996 at $1.00 per share -- -- -- -- Exercise of stock options and warrants -- -- -- -- Sales of common stock in February and March 1997 at $3.00 per share, less offering costs of $1,039,668 -- -- -- -- Issuance of warrants on March 24, 1997 to purchase 25,000 shares of common stock at $3.00 per share -- -- -- -- Issuance of stock options on April 13, 1998 to purchase 100,000 shares of common stock at $8.46 per share -- -- -- -- Fair market value of conversion feature on debenture issued June 30, 1998 -- -- -- -- Issuance of warrants on June 30, 1998 to purchase 350,000 shares of common stock at $7.29 and $7.50 per share -- -- -- -- Issuance of stock options on April 1, 1998 and September 15, 1998 to purchase 423,000 shares of common stock at $3.00 to $6.42 per share -- -- -- -- Unearned compensation grant -- -- -- -- Unearned compensation amortization -- -- -- -- Unearned compensation reversal related to employee terminations -- -- -- -- Other -- -- -- -- Net loss -- -- -- -- ------------ ------------ ------------ ------------ Balance as of December 31, 1998 -- -- -- -- Sale of stock warrants during September 1999 to purchase 320,000 shares of common stock at $.84 - $1.00 per share -- -- -- -- Unearned compensation amortization -- -- -- -- Unearned compensation reversal related to employee termination -- -- -- -- Exercise of stock options -- -- -- -- Compensation element of stock option vesting to consultants -- -- -- -- Issuance of preferred stock and warrant, less offering costs of $74,461 13,125 131 -- -- Accretion of preferred stock beneficial conversion feature -- -- -- -- Conversion of debentures -- -- -- -- Net loss -- -- -- -- ------------ ------------ ------------ ------------ Balance as of December 31, 1999 13,125 131 -- -- Issuance of preferred stock and warrant, less offering costs of $16,481 6,750 68 -- -- Accretion of preferred stock beneficial conversion feature -- -- -- -- Conversion of debentures -- -- -- -- Issuance of stock options and warrants to nonemployees -- -- -- -- Net loss -- -- -- -- ------------ ------------ ------------ ------------ Balance as of December 31, 2000 19,875 199 -- -- Conversion of Series A preferred stock and cumulative dividends in arrears to common stock (1,431) (14) -- -- Issuance of Series B preferred stock in exchange for Series A preferred stock and dividends in arrears, less offering costs of $40,500 (18,444) (185) 21,430 214 Accretion of preferred stock beneficial conversion feature -- -- -- -- Conversion of debentures and accrued interest to common stock -- -- -- -- Fair value of beneficial conversion feature on debenture -- -- -- -- Issuance of stock options and warrants to nonemployees -- -- -- -- Net loss -- -- -- -- ------------ ------------ ------------ ------------ Balance as of December 31, 2001 -- $ -- 21,430 $ 214 ============ ============ ============ ============ [WIDE TABLE CONTINUED FROM ABOVE] Common Stock Additional ----------------------------- contributed Shares Amount capital ------------ ------------ ------------ Sale of common stock January 7, 1993 3,150,000 $ 31,500 $ (22,750) Sale of common stock January 7, 1993 at $.02 per share 1,350,000 13,500 11,500 Redemption of director and officers common stock August 4, 1995 at $0 per share (270,000) (2,700) 2,700 Sales of common stock August 4, 1995 through December 22, 1995 at $.17 through $.24 per share 1,237,500 12,376 262,624 Redemption of common stock August 4, 1995 through December 22, 1995 at $.22 through $.24 per share (1,350,000) (13,500) (265,324) Issuance of detachable warrants on

May 17, 1996, in connection with bridge financing arrangements, valued at $25,000, to purchase 100,000 shares of common stock at $1.00 per share -- -- 25,000 Sales of common stock during June and July, 1996 at $1.00 per share, less offering costs of $124,663 698,160 6,982 566,515 Conversion of bridge notes plus accrued interest of $1,841 to common stock on June 28, 1996 at $1.00 per share 201,840 2,018 178,990 Exercise of stock options and warrants 73,367 733 183,159 Sales of common stock in February and March 1997 at $3.00 per share, less offering costs of $1,039,668 2,420,000 24,200 6,196,132 Issuance of warrants on March 24, 1997 to purchase 25,000 shares of common stock at $3.00 per share -- -- 27,500 Issuance of stock options on April 13, 1998 to purchase 100,000 shares of common stock at $8.46 per share -- -- 352,650 Fair market value of conversion feature on debenture issued June 30, 1998 -- -- 525,000 Issuance of warrants on June 30, 1998 to purchase 350,000 shares of common stock at $7.29 and $7.50 per share -- -- 432,000 Issuance of stock options on April 1, 1998 and September 15, 1998 to purchase 423,000 shares of common stock at $3.00 to $6.42 per share -- -- 237,500 Unearned compensation grant -- -- 408,920 Unearned compensation amortization -- -- -- Unearned compensation reversal related to employee terminations -- -- (184,191) Other -- -- 22,210 Net loss -- -- -- ------------ ------------ ------------ Balance as of December 31, 1998 7,510,867 75,109 8,960,135 Sale of stock warrants during September 1999 to purchase 320,000 shares of common stock at $.84 - $1.00 per share -- -- 80,000 Unearned compensation amortization -- -- -- Unearned compensation reversal related to employee termination -- -- (42,920) Exercise of stock options 26,000 260 28,240 Compensation element of stock option vesting to consultants -- -- 36,100 Issuance of preferred stock and warrant, less offering costs of $74,461 -- -- 800,408 Accretion of preferred stock beneficial conversion feature -- -- 285,000 Conversion of debentures 1,569,390 15,694 1,326,306 Net loss -- -- -- ------------ ------------ ------------ Balance as of December 31, 1999 9,106,257 91,063 11,473,269 Issuance of preferred stock and warrant, less offering costs of $16,481 -- -- 433,451 Accretion of preferred stock beneficial conversion feature -- -- 141,000 Conversion of debentures 860,467 8,604 541,396 Issuance of stock options and warrants to nonemployees -- -- 544,484 Net loss -- -- -- ------------ ------------ ------------ Balance as of December 31, 2000 9,966,724 99,667 13,133,600 Conversion of Series A preferred stock and cumulative dividends in arrears to common stock 670,445 6,704 18,232 Issuance of Series B preferred stock in exchange for Series A preferred stock and dividends in arrears, less offering costs of $40,500 -- -- 240,520 Accretion of preferred stock beneficial conversion feature -- -- 451,000 Conversion of debentures and accrued interest to common stock 1,891,300 18,914 494,887 Fair value of beneficial conversion feature on debenture -- -- 113,000 Issuance of stock options and warrants to nonemployees -- -- 1,086,786 Net loss -- -- -- ------------ ------------ ------------ Balance as of December 31, 2001 12,528,469 $ 125,285 $ 15,538,025 ============ ============ ============ [WIDE TABLE CONTINUED FROM ABOVE] Deficit accumulated Deferred during the compensation development related to stage stock options Total ------------ ------------ ------------ Sale of common stock January 7, 1993 $ (8,747) $ -- $ 3 Sale of common stock January 7, 1993 at $.02 per share -- -- 25,000 Redemption of director and officers common stock August 4, 1995 at $0 per share -- -- -- Sales of common stock August 4, 1995 through December 22, 1995 at $.17 through $.24 per share -- -- 275,000 Redemption of common stock August 4, 1995 through December 22, 1995 at $.22 through $.24 per share (29,350) -- (308,174) Issuance of detachable warrants on May 17, 1996, in connection with bridge financing arrangements, valued at $25,000, to purchase 100,000 shares of common stock at $1.00 per share -- -- 25,000 Sales of common stock during June and July, 1996 at $1.00 per share, less offering costs of $124,663 -- -- 573,497 Conversion of bridge notes plus accrued interest of $1,841 to common stock on June 28, 1996 at $1.00 per share -- -- 181,008 Exercise of stock options and warrants -- -- 183,892 Sales of common stock in February and March 1997 at $3.00 per share, less offering costs of $1,039,668 -- -- 6,220,332 Issuance of warrants on March 24, 1997 to purchase 25,000 shares of common stock at $3.00 per share -- -- 27,500 Issuance of stock options on April 13, 1998 to purchase 100,000 shares of common stock at $8.46 per share -- -- 352,650 Fair market value of conversion feature on debenture issued June 30, 1998 -- -- 525,000 Issuance of warrants on June 30, 1998 to purchase 350,000 shares of common stock at $7.29 and $7.50 per share -- -- 432,000 Issuance of stock options on April 1, 1998 and September 15, 1998 to purchase 423,000 shares of common stock at $3.00 to $6.42 per share -- -- 237,500 Unearned compensation grant -- (408,920) -- Unearned compensation amortization -- 167,839 167,839 Unearned compensation reversal related to employee terminations -- 184,191 -- Other -- -- 22,210 Net loss (9,496,871) -- (9,496,871) ------------ ------------ ------------ Balance as of December 31, 1998 (9,534,968) (56,890) (556,614) Sale of stock warrants during September 1999 to purchase 320,000 shares of common stock at $.84 - $1.00 per share -- -- 80,000 Unearned compensation amortization -- 13,970 13,970 Unearned compensation reversal related to employee termination -- 42,920 -- Exercise of stock options -- -- 28,500 Compensation element of stock option vesting to consultants -- -- 36,100 Issuance of preferred stock and warrant, less offering costs of $74,461 -- -- 800,539 Accretion of preferred stock beneficial conversion feature (285,000) -- -- Conversion of debentures -- -- 1,342,000 Net loss (3,428,357) -- (3,428,357) ------------ ------------ ------------ Balance as of December 31, 1999 (13,248,325) -- (1,683,862) Issuance of preferred stock and warrant, less offering costs of $16,481 -- -- 433,519 Accretion of preferred stock beneficial conversion feature (141,000) -- -- Conversion of debentures -- -- 550,000 Issuance of stock options and warrants to nonemployees -- -- 544,484 Net loss (3,130,453) -- (3,130,453) ------------ ------------ ------------ Balance as of December 31, 2000 (16,519,778) -- (3,286,312) Conversion of Series A preferred stock and cumulative dividends in arrears to common stock (24,922) -- -- Issuance of Series B preferred stock in exchange for Series A preferred stock and dividends in arrears, less offering costs of $40,500 (281,049) -- (40,500) Accretion of preferred stock beneficial conversion feature (451,000) -- -- Conversion of debentures and accrued interest to common stock -- -- 513,801 Fair value of beneficial conversion feature on debenture -- -- 113,000 Issuance of stock options and warrants to nonemployees -- -- 1,086,786 Net loss (2,283,774) -- (2,283,774) ------------ ------------ ------------ Balance as of December 31, 2001 $(19,560,523) $ -- $ (3,896,999) ============ ============ ============ The accompanying notes are an integral part of this statement. F-5 BIO-key International, Inc. (a Corporation in the Development Stage) STATEMENTS OF CASH FLOWS January 7, 1993 (date of inception) Years ended December 31, through -- December 31, 1999 2000 2001 2001 ------------ ------------ ------------ ------------ Cash flows from operating activities Net loss $ (3,428,357) $ (3,130,453) $ (2,283,774) $(18,339,455) Adjustments to reconcile net loss to net cash used in operating activities: Depreciation 58,650 47,315 31,942 242,913 Amortization Unearned compensation 13,970 -- -- 193,333 Deferred financing costs 288,543 53,287 11,524 426,397 Intrinsic value of beneficial conversion feature of convertible debenture 124,624 36,701 60,863 622,564 Allowance for doubtful receivables (158,000) -- -- -- Write-down of inventory 283,515 32,500 -- 916,015 Write-down of deferred financing costs 132,977 -- -- 132,977 Gain on sale of Inter-Con/PC, Inc. stock (190,000) -- -- (190,000) Revenues realized due to offset of billings against a -- -- -- (170,174) stock repurchase Acquired research and development -- -- -- 117,000 Options and warrants issued for services and other 36,100 544,484 70,786 1,401,020 Other -- -- -- 34,684 Change in assets and liabilities: Accounts receivable 189,371 4,213 9,118 -- Inventories 94,272 -- -- (916,015) Prepaid expenses 78,755 21,375 (184,889) (206,634) Accounts payable 60,156 (12,637) (89,902) 238,496 Accrued liabilities 215,394 679,892 448,607 1,581,256 ------------ ------------ ------------ ------------ Net cash used in operating activities (2,200,030) (1,723,323) (1,925,725) (13,915,623) Cash flows from investing activities Capital expenditures (2,438) -- -- (242,913) Proceeds from sale of Inter-Con/PC, Inc. stock 190,000 -- -- 190,000 Other (9,035) (12,518) (2,635) (41,706) ------------ ------------ ------------ ------------ Net cash provided by (used in) investing 178,527 (12,518) (2,635) (94,619) activities Cash flows from financing activities Net borrowings under short-term borrowing agreements 250,000 1,500,000 1,370,000 3,003,000 Issuance of convertible bridge notes -- -- -- 175,000 Issuance of convertible debentures and long-term notes -- -- 1,065,000 2,840,000 Issuance of warrants and convertible debentures discount 80,000 -- -- 830,000 Deferred financing costs -- -- -- (312,977) Exercise of stock options and warrants 28,500 -- -- 190,799 Sale of common stock -- -- -- 7,093,832 Sale of preferred stock and assigned value of warrant 700,539 183,519 (40,500) 843,558 Redemption of common stock -- -- -- (138,000) ------------ ------------ ------------ ------------ Net cash provided by financing activities 1,059,039 1,683,519 2,394,500 14,525,212 ------------ ------------ ------------ ------------ NET INCREASE (DECREASE) IN CASH (962,464) (52,322) 466,140 514,970 Cash and cash equivalents, beginning of period 1,063,616 101,152 48,830 -- ------------ ------------ ------------ ------------ Cash and cash equivalents, end of period $ 101,152 $ 48,830 $ 514,970 $ 514,970 ============ ============ ============ ============ The accompanying notes are an integral part of these statements. F-6 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE A - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Nature of Business BIO-key International, Inc., formerly SAC Technologies, Inc. (the Company) is a development stage company incorporated on January 7, 1993 and has operations in Minneapolis, Minnesota and Las Vegas, Nevada. The Company's goal is to develop and market advanced biometric fingerprint technology solutions that provide fast, easy and highly secure personal identification for online access to computers and networks. The Company's fingerprint identification techniques can be used without the aid of a personal identification number. The Company's target market includes Internet application service providers, Internet based retailers and other operators of private networks, and entities where security and identification applications are required, including the aviation industry. Basis of Presentation Broad commercial acceptance of the Company's technology is critical to the Company's success and ability to generate revenues. The Company has had no significant revenues to date, and has accumulated losses since inception of approximately $18,339,000, of which approximately $2,284,000 was incurred during 2001. As of December 31, 2001, there was a stockholders' deficit of approximately $3,897,000. The Company is in need of substantial additional capital. The Company is currently considering various alternatives related to raising additional capital including continued funding from an investment group and new funding from other sources. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained to meet its needs, or that such financing would not be dilutive to existing stockholders. The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which contemplate continuation of the Company as a going concern. The matters described in the preceding paragraphs raise substantial doubt about the Company's ability to continue as a going concern. Recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon the Company advancing beyond the development stage, which in turn is dependent upon the Company's ability to obtain additional financing, meet its financing requirements on a continuing basis, and succeed in its future operations. The accompanying financial statements do not include any adjustments that might be necessary should the Company be unable to continue in existence. F-7 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE A - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Summary of Significant Accounting Policies A summary of the significant accounting policies consistently applied in the preparation of the accompanying financial statements follows: 1. Revenue Recognition Revenues from software licensing is recognized in accordance with Statement of Position (SOP) No. 97-2, Software Revenue Recognition, as amended by SOP No. 98-9. 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 collectibility is probable. The Company intends to enter into arrangements with end users for items which may include software license fees, usage 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, each element of the arrangement will be analyzed and the Company will allocate a portion of the total fee under the arrangement to the elements using vendor specific objective evidence of fair value of the element, regardless of any separate prices stated within the contract for each element. Vendor specific objective evidence is based on the price the customer is required to pay when the element is sold separately (i.e., software license fees charged when consulting or other services are not provided, hourly rates charged for consulting services when sold separately from a software license or usage fees). If vendor specific objective evidence of fair value does not exist for any undelivered elements, all revenue is deferred and recognized ratably over the service period if the undelivered element is services, or until sufficient objective evidence of fair value exists or all elements have been delivered. 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. Service revenues: Revenues from services are comprised of consulting and implementation services. 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 or 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. F-8 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS (Including Data Applicable to the Unaudited Periods) NOTE A - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED 1. Revenue Recognition - Continued Usage fees: Usage fees are charged on certain applications based on the customer's volume of use. Usage revenue is recognized based on the actual level of activity used by the customer or, in the case of fixed-fee arrangements, ratably over the arranged time period. Although each sale will be separately negotiated, the Company does not anticipate offering customers any extended payment terms. 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. 2. Cash and Cash Equivalents Cash equivalents consist of certificates of deposit and all other liquid investments with original maturities of three months or less. The Company maintains its cash balances in a financial institution in Nevada. These balances are insured by the Federal Deposit Insurance Corporation up to $100,000. 3. Equipment, Furniture and Fixtures Equipment, furniture and fixtures are stated at cost. Depreciation is provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated services lives of three and five years using the straight-line method. Equipment, furniture and fixtures consisted of the following as of December 31: 2000 2001 ----------- ----------- Equipment $ 206,363 $ 206,363 Furniture and fixtures 36,550 36,550 ----------- ----------- 242,913 242,913 Less accumulated depreciation 210,971 242,913 ----------- ----------- $ 31,942 $ -- =========== =========== 4. Advertising Expense The Company expenses the costs of advertising as incurred. Advertising expenses for the years ended December 31, 1999, 2000, 2001, and the period January 7, 1993 (date of inception) through December 31, 2001 were approximately $63,000, $6,000, $1,000 and $216,000, respectively. F-9 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE A - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED 5. Research and Development Expenditures All costs related to development of new products are charged to expense as incurred. Such costs are required to be expensed until technological feasibility and proven marketability of the product are established. 6. Basic and Diluted Loss per Common Share Basic and diluted loss per share for all periods presented is computed using the weighted average number of common shares outstanding. Basic weighted average shares outstanding include only outstanding common shares. Shares reserved for outstanding warrants, stock options or convertible preferred stock are not considered because the impact of the incremental shares is antidilutive. 7. Income Taxes The Company provides for income taxes based on income reported for financial reporting purposes. Certain charges to earnings differ as to timing from those deducted for tax purposes; these relate primarily to net operating loss carryforwards. The tax effect of these differences are recorded as deferred income taxes. 8. Accounting for Stock-Based Compensation The Company uses the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25) in accounting for employee stock options. Under the intrinsic value method, compensation expense is recognized only to the extent the market price of the common stock exceeds the exercise price of the stock option at the date of the grant. In the future, if employees exercise certain nonstatutory stock options, the Company may realize a tax benefit equal to the tax effect on the difference between the strike price of the option and the fair market value of the stock on the day of exercise. Tax benefits realized, if any, by the Company will be credited to additional paid-in capital. Similar accounting treatment is also given to any tax benefits the Company may realize arising from employees making disqualifying dispositions of incentive stock options. F-10 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE A - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED 9. Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 receivables and expenses during the reporting period, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Estimates are used for such items as valuation of deferred income taxes, conversion features of convertible debentures and preferred stock, and stock options and warrants outstanding. NOTE B - PREPAID EXPENSES Prepaid expenses consisted of the following at December 31, 2001: 2000 2001 ----------- ----------- Consulting fees $ -- $ 188,275 Insurance 21,745 18,359 ----------- ----------- $ 21,745 $ 206,634 =========== =========== In November 2001, the Company entered into agreements with consultants under which the consultants will arrange to make introductions of senior executives of entities which may become business partners of the Company. The terms of the consulting agreements required an initial cash payment of approximately $332,000. As discussed further in Note H, the agreements also call for contingent additional fees based on future sales, if any, generated by these introductions. The prepaid fees are being amortized to expense over the ten-month term of the agreements. NOTE C - OTHER ASSETS Other assets consisted of the following as of December 31: 2000 2001 ----------- ----------- Patents pending $ 22,948 $ 26,706 Security deposits 16,123 15,000 Other 11,524 -- ----------- ----------- $ 50,595 $ 41,706 =========== =========== F-11 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE D - ACCRUED LIABILITIES Accrued liabilities consisted of the following as of December

31: 2000 2001 ------------- ------------- Penalties due investment group $ 763,625 $ -- Interest 256,071 42,509 Compensation 85,680 36,699 Other 16,313 11,367 ------------- ------------- $ 1,121,689 $ 90,575 ============= ============= As discussed further in Note F, the Company had accrued penalties payable to an investment group for not timely filing a registration statement in connection with the Company's issuance of its Series A Preferred Stock. As discussed further in Note F, all accrued penalties were converted into a long-term debenture in November 2001. NOTE E - RECAPITALIZATION TRANSACTION. On November 26, 2001, the Company completed a recapitalization transaction (the Transaction) with an investment group (the Investor). As a result of the Transaction, the Company converted approximately $4.6 million of short-term debt and accruals into long-term convertible notes and debentures, obtained $1.065 million of additional funding and issued shares of its newly designated Series B 9% convertible preferred stock in exchange for all of the issued and outstanding shares of its Series A 9% convertible preferred stock and the cumulative dividends in arrears due thereon. Additionally, the Investor forgave $300,250 of previously accrued penalties which has been treated as an extraordinary gain in 2001 in the accompanying financial statements. Under the terms of the Transaction, the Investor agreed to provide up to $1.08 million of additional financing in incremental monthly installments during the six-month period commencing March 1, 2002, subject to certain conditions being satisfied. NOTE F - NOTES PAYABLE Notes payable consisted of the following as of December 31: 2000 2001 ----------- ----------- Notes payable to investment group with interest at 10%; unsecured, converted to long-term in 2001 $ 1,400,000 $ -- =========== =========== All of the above short-term notes were converted to a long-term note in November 2001 as part of the Transaction discussed in Note D. F-12 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE G - LONG-TERM OBLIGATIONS Long-term obligations consisted of the following as of December 31: 2000 2001 ---------- ---------- Secured convertible note, 10% $ -- $ 4,092,920 Zero interest convertible debenture -- 1,000,000 Convertible debenture, 5% 598,455 316,000 Discounts assigned to fair values of conversion feature and warrants -- (1,077,682) ---------- ---------- 598,455 4,331,238 Less current maturities (598,455) -- ---------- ---------- $ -- $ 4,331,238 ========== ========== A summary of the Company's long-term notes and debentures issued as part of the Transaction are as follows: * SECURED CONVERTIBLE NOTE. Prior to the Transaction, the Company had unsecured short-term notes from the Investor in the aggregate principal amount of $2,770,000. The Investor converted this amount and associated accrued interest of $257,920 together with additional financing of $1,065,000 into a secured convertible note in the principal amount of $4,092,920 (the Convertible Note). The Convertible Note is due September 30, 2003 and accrues interest at 10%, payable quarterly commencing September 2002. The note is convertible into shares of the Company's common stock at a conversion price of $0.75 per share. The note is collateralized by substantially all of the Company's assets. In conjunction with the issuance of the Convertible Note, the Company issued a warrant to the Investor to purchase 4,000,000 shares of common stock at $1.00 per share through November 26, 2006. The Convertible Note was recorded net of a $1,016,000 discount assigned to the fair value or the warrant. The value assigned to the warrant is being amortized as interest expense over the twenty-two month life of the Convertible Note. The fair value assigned to the warrant was estimated on the grant date using the Black-Scholes pricing model. The assumptions used to determine the fair value of the grant included the following assumptions: risk-free interest rate of 3.5%, expected life of three years, stock price volatility of 175%, and expected dividends of zero. F-13 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE G - LONG-TERM OBLIGATIONS - CONTINUED * ZERO INTEREST CONVERTIBLE DEBENTURE. During the past two years, the Company had accrued penalties under a previous registration rights agreement with the Investor in the amount of $1,300,250. The Investor agreed to reduce the penalty by $300,250 and converted the balance into a convertible debenture in the principal amount of $1,000,000. The debenture is due September 30, 2003 and bears a stated interest rate of zero. The debenture is convertible into shares of the Company's common stock at a conversion price of $0.75 per share. The $300,250 reduction in previously accrued penalties has been treated as an extraordinary gain for 2001 in the accompanying financial statements. * 5% CONVERTIBLE DEBENTURE: A convertible debenture in the principal amount of $539,625 was issued in exchange for the cancellation of an outstanding 5% debenture in the principal amount of $418,000 plus accrued interest of $121,625. The new convertible debenture is due September 30, 2003 and accrues interest at 5%, payable quarterly commencing in August 2002. The new debenture is convertible into shares of the Company's common stock at a per share conversion price equal to the lesser of $0.75 or a 22% discount to the average of the closing price of the common stock for the five days preceding conversion. The new convertible debenture was recorded net of a $113,000 discount assigned to the fair value of the beneficial conversion feature. The value assigned to the conversion feature is being amortized as interest expense over the twenty-two month life of the debenture in accordance with Emerging Issues Task Force (EITF) No. 00-27 and EITF No. 98-5. Primarily all of the Company's interest expense was related to obligations due the Investor. The conversion and exercise prices of the Company's convertible instruments, options and warrants discussed here and elsewhere were determined by individual negotiation between the Company and the individual security holder or grantee. NOTE H - COMMITMENTS AND CONTINGENCIES Operating Leases The Company operates a leased facility in Minnesota under a non-cancelable operating lease that expires in August 2004. In addition to base rent, the Company pays for property taxes, maintenance, insurance, and other occupancy expense applicable to the leased premises. Minimum rental commitments of non-cancelable operating leases are approximately as follows: Year ending December 31, 2002 $ 40,000 Year ending December 31, 2003 42,000 Year ending December 31, 2004 29,000 ----------- $ 111,000 =========== F-14 Rental expense was approximately $124,000, $89,000, $70,000 and $489,000 during 1999, 2000, 2001 and for the period January 7, 1993 (date of inception) through December 31, 2001, respectively. BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE H - COMMITMENTS AND CONTINGENCIES - CONTINUED Contingent Consultant Fees In November 2001, the Company entered into an agreement with a consultant and an associate. In addition to fixed fees, the agreement requires contingent future consulting fees to be paid based on future sales, if any, generated by introductions, as defined, made by the consultant. The contingent fee is to be 2.19% of such sales, including product sales, sale or licensing of technology, or sale of an equity interest in the Company. The consultant and the associate have the option to convert the contingent fees, if any, into shares of the Company's common stock (but no more than 525,000 shares) at a conversion price of $0.38 per share. The agreement expires in August 2002. Employment Agreements The Company has employment agreements with four individuals. The employment agreements contain non-compete clauses that restrict the employees from competing with the Company following a termination of employment from the Company. In the event of termination, as defined, the agreements provide each employee with severance payments. As of December 31, 2001, the aggregate commitment was approximately $372,000. Litigation Settlements During 1999, a former licensor of technology to the Company commenced litigation claiming breach of contract. The Company filed a counter-claim. In August 2001, the Company and the plaintiff reached a settlement whereby both parties release each other from all claims, the plaintiff agreed to deliver copies of certain software to the Company, and the Company agreed to pay $50,000 to the plaintiff in various installments through April 2002. The entire settlement amount was charged to expense in 2001. The remaining unpaid balance was $30,000 as of December 31, 2001 and March 31, 2002. In July 2000, litigation was commenced against the Company alleging breach of a licensing agreement and conversion of certain proprietary technology. In August 2000, the Company and plaintiff reached a settlement and entered into a new agreement whereby: a) ownership of each of the parties' technologies was clarified; b) previously existing contracts between the two parties were terminated; c) royalties or payables due between the two parties were discharged; d) the Company granted the plaintiff certain royalty-free rights and licenses to manufacture and sell certain hardware devices; and e) the Company granted the plaintiff certain other rights, including the right to purchase certain inventory items at terms and prices similar to those offered to other customers. F-15 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE H - COMMITMENTS AND CONTINGENCIES - CONTINUED Future Public Offering Costs In June 1998, the Company entered into an agreement with its underwriter, whereby the underwriter agreed to waive all future rights of first refusal to sell the Company's securities. In exchange for this, the Company agreed to pay the underwriter $100,000, of which $34,000 was paid at the closing of the sale of certain debentures and $66,000 is due upon completion of a future public offering, if one occurs. NOTE I - STOCKHOLDERS' EQUITY Issuance of Series B 9% Convertible Preferred Stock In November 2001, the Company issued 21,430 shares of its newly authorized Series B 9% convertible preferred stock (the Series B Preferred Stock) in exchange for all 18,449 outstanding shares of its Series A 9% convertible preferred stock (the Series A Preferred Stock) and cumulative dividends in arrears of $281,049 due thereon. Issuance of Series B 9% Convertible Preferred Stock - Continued The Series B Preferred Stock accrues dividends of 9% payable semi-annually on June 15 and December 15 in cash, or at the option of the Company, in additional shares of its common stock. As of December 31, 2001, cumulative dividends in arrears were approximately $10,000. The Series B shares are redeemable only at the option of the Company, so long as the

Company's common stock is eligible for quotation on the OTC Bulletin Board and the shares issuable upon conversion are subject to an effective registration statement. The Series B shares are convertible into shares of the Company's common stock at a per share conversion price equal to the lesser of $0.75 or a 22% discount to the average closing price of the common stock for the five days preceding conversion. The Series B shares have no voting rights. The fair value assigned to the beneficial conversion feature of the Series B shares was $451,000. The $451,000 is analogous to a dividend and was immediately recognized as a return to the preferred stockholder since the Series B shares are immediately convertible into common stock. The terms of a Registration Rights Agreement with the Investor require the Company to file a registration statement with the SEC covering the resale of any shares of common stock issuable upon any conversion of the Series B Preferred Stock or convertible debt or the exercise of any of the Investor's warrants. If the Company does not file the registration statement with the SEC by March 31, 2002 or if such registration statement is not declared effective by the SEC by May 30, 2002, the Company is required to pay a penalty to the Investor equal to 2% of the outstanding face value of the preferred stock. F-16 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE I - STOCKHOLDERS' EQUITY - CONTINUED Issuances of Series A 9% Convertible Preferred Stock In July 1999, the Company issued to the Investor 13,125 shares of its Series A 9% Preferred Stock. The face value of the preferred stock issued was $1,312,500. In conjunction with the issuance of preferred stock, the Company also issued to the Investor a warrant to purchase 131,250 shares of the Company's common stock at $1.196 per share exercisable through June 2004. The Company received net cash proceeds of $700,539 after giving effect to a $437,500 discount to the face value of the Preferred Stock, offering costs of $74,461 and repayment of a $100,000 note to the Investor. The fair value assigned to the beneficial conversion feature of the 13,125 Series A shares was $285,000. The $285,000 fair value of the conversion feature is analogous to a dividend and was immediately recognized as a return to the preferred stockholder since the Series A shares were immediately convertible into common stock. In March 2000, the Company issued to the Investor 6,750 shares of its Series A 9% Preferred Stock. The face value of the preferred stock was $675,000. In conjunction with the issuance of the preferred stock, the Company also issued to the Investor a warrant to purchase 67,500 shares of common stock at $1.309 per share exercisable through March 2005. The Company received net cash proceeds of $183,519 after giving effect to a $225,000 discount to the face amount of the preferred stock, offering costs of $16,481, and repayment of $250,000 of notes outstanding to the Investor. The fair value assigned to the beneficial conversion feature of the 6,750 Series A shares was $141,000. The $141,000 fair value of the conversion feature is analogous to a dividend and was immediately recognized as a return to the preferred stockholder since the Series A shares were immediately convertible into common stock. The Series A shares issued in 1999 are convertible into shares of common stock at a conversion price equal to the lesser of: (a) $1.10, or (b) a 22% discount to the average closing price of the Company's common stock of the five days prior to conversion. The Series A shares issued in 2000 are convertible into shares of common stock at a conversion price equal to the lesser of (a) $1.169 or (b) a 22% discount to the average closing price of the Company's common stock of the five days prior to conversion. The conversion prices are subject to adjustment in the event the Company issues additional common stock options, warrants or other convertible securities without consideration, or for consideration per share less than the effective conversion price in effect on the date of issuance, as defined. In conjunction with the issuance of the Series B Preferred Stock, all previously issued shares of Series A Preferred Stock were retired and canceled and became authorized but unissued shares of preferred stock. F-17 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE I - STOCKHOLDERS' EQUITY - CONTINUED Warrants The Company has issued warrants to certain creditors, investors, underwriters and consultants. A summary of warrant activity is as follows: Exercisable at Price per Expiration December 31, Outstanding share date 2001 ------------- ------------- ------------- -------------- Balance, December 31, 1998 639,716 413,216 Granted in connection with issuance of Series A preferred stock 131,250 1.20 2004 131,250 Sold to outside investors 320,000 0.84-1.00 2002 320,000 Expired (92,500) 1.00-3.00 -- - -------------- -------------- Balance, December 31, 1999 998,466 864,466 Granted in connection with issuance of Series A preferred stock 67,500 1.31 2005 67,500 Granted to acquire software 400,000 1.00 2004 400,000 Granted to consultants 50,000 1.00 2005 50,000 -------------- -------------- Balance, December 31, 2000 1,515,966 1,381,966 Granted in connection with 10% secured convertible note payable 4,000,000 1.00 2006 4,000,000 Granted to consultants 295,932 0.38-1.00 2006 295,932 -------------- -------------- Balance, December 31, 2001 5,811,898 5,677,898 ============== ============== Exercised through December 31, 2001 7,500 ============== F-18 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE I - STOCKHOLDERS' EQUITY - CONTINUED Warrants - Continued The estimated fair value of the warrants granted during 1999, 2000 and 2001 was $54,000, $220,500 and $1,171,000, respectively. The estimated fair value of the 295,932 warrants granted to consultants in 2001 was $150,000 of the $1,171,000 total for the year. The fair value of warrants is estimated as of the grant date using the Black-Scholes pricing model utilizing the same assumptions described in Note J. The estimated fair value of warrants granted for goods and services are amortized and charged to expense in over the period earned. NOTE J - 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 terminates in May 2006. 1999 Stock Option Plan During 1999, the Board of Directors of the Company adopted the 1999 Stock Option Plan (the 1999 Plan). The 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 Plan terminates in August 2009. Non-Plan Stock Options Periodically, the Company has granted options outside of the 1996 and 1999 Plans to various employees and consultants. In the event of change in control, as defined, certain of the non-plan options outstanding vest immediately. F-19 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE J - STOCK-BASED COMPENSATION - CONTINUED Summary of Option Information Information summarizing option activity is as follows: Number of shares Weighted --- Range of average 1996 1999 Non- exercise exercise plan plan Plan Total prices price --------- --------- --------- --------- --------- --------- Balance, December 31, 1998 474,334 -- 498,000 972,334 $1.00-10.75 $ 3.74 Granted 300,000 885,548 540,000 1,725,548 .50 -1.00 .91 Exercised (26,000) -- -- (26,000) 1.00 -1.13 1.10 Expired or canceled (278,009) -- -- (278,009) 1.13-10.75 3.74 --------- --------- --------- --------- Balance, December 31, 1999 470,325 885,548 1,038,000 2,393,873 .50-10.75 1.73 Granted -- 400,000 850,000 1,250,000 .27 -1.22 .74 Relinquished (185,610) (222,000) -- (407,610) .88 - .91 .89 Expired or cancelled (170,335) (446,879) (407,000) (1,024,214) .88-10.75 1.80 --------- --------- --------- --------- Balance, December 31, 2000 114,380 616,669 1,481,000 2,212,049 .27 -6.42 1.28 Granted 276,000 840,000 730,000 1,846,000 .19 - .46 .40 Expired or canceled -- -- (230,000) (230,000) .27 - .91 .54 --------- --------- --------- --------- Balance, December 31, 2001 390,380 1,456,669 1,981,000 3,828,049 .19 -6.42 .86 ========= ========= ========= ========= Available for future grants, December 31, 2001 266,620 543,331 NA 809,951 ========= ========= ========= ========= Additional information regarding outstanding options as of December 31, 2001 is as follows: Shares exercisable under Shares under outstanding options outstanding options --- --------------------- Weighted Weighted average Weighted Range of average remaining average exercise Number of exercise life Number exercise prices shares price (in years) exercisable price --------- --------- --------- --------- --------- --------- $ .27 -.50 1,796,000 $ .30 6.3 1,156,000 $ .35 .63 -.97 1,353,049 .76 4.6 501,049 .76 1.00-3.00 626,000 2.22 1.6 626,000 2.22 3.22-6.42 53,000 6.12 5.7 53,000 6.12 F-20 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE J - STOCK-BASED COMPENSATION - CONTINUED Summary Option Information - Continued The weighted average fair value of options granted to employees and directors during 1999, 2000 and 2001 were $0.84, $0.69 and $0.15 per share, respectively. The fair value of each option grant is estimated as of the date of the grant using the Black-Scholes option-pricing model utilizing the same assumptions presented in the proforma compensation disclosure section below. During 1997 and 1998, options for 360,000 and 40,000 shares, respectively, were granted to employees at per share exercise prices less than the fair market value of the common stock at the date of issuance. The difference between the option exercise price and estimated fair value of common stock at the date of grant for these options was $225,400 and $58,520, respectively, and has been reflected as unearned compensation in the accompanying balance sheets and is being recognized as expense over the vesting period of the grants. In connection with certain employee terminations, $184,191 and $42,920 of unearned compensation was reversed during 1997 and 1999, respectively, with no resulting impact to the statement of operations. Options were granted to consultants and strategic partners during 1999, 2000 and 2001 totaling 540,000, 570,000 and 276,000 shares, respectively.. The estimated fair value of the options granted to consultants and strategic partners which vested in 1999, 2000 and 2001 was $147,875, $323,984 and $1,387,000, respectively. Proforma Compensation Disclosure The Company has adopted Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" (SFAS No. 123) which encourages, but does not require, a fair-value based method of accounting for employee stock options. As permitted under SFAS 123, the Company has continued to account for employee stock options using the intrinsic value method outlined in APB 25, "Accounting for Stock Issued to Employees." Accordingly, no compensation expense has been recognized by the Company for its stock options granted to employees or directors. F-21 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE J - STOCK-BASED COMPENSATION - CONTINUED Proforma Compensation Disclosure - Continued If compensation expense for the stock options granted had been determined based on the fair value at the grant dates consistent with the method of SFAS No. 123, the Company's proforma net loss and proforma loss per share would have been as follows: January 7, 1993 (date of inception) Years ended December 31, through --- December 31, 1999 2000 2001 2001 ------------ ------------ ------------ ------------ Net loss As reported $ (3,428,357) $ (3,130,353) $ (2,283,774) $(18,339,455) Proforma (3,760,357) (3,313,353) (2,480,774) (18,536,455) Loss applicable to common stockholders As reported $ (3,769,957) $ (3,437,678) $ (2,834,252) $(19,538,758) Proforma (4,101,957) (3,620,578) (3,031,252) (19,735,758) Basic and diluted loss per common share As reported $ (.45) $ (.36) $ (.26) $ (2.86) Proforma (.49) (.38) (.28) (2.89) In determining the proforma compensation cost of the options granted, the fair value of each grant was estimated on the date of grant using the Black-Scholes option pricing model. The assumptions used to determine the fair value of each grant included the following weighted average assumptions: 1999 2000 2001 ----- ----- ----- Risk free interest rate 6.30% 5.00% 3.50% Expected life of options (in years) 4.00 4.00 3.00 Expected dividends -- -- -- Volatility of stock price 187% 1,655% 175% F-22 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE K - INCOME TAXES Deferred taxes are due to income tax credits and net operating loss carryforwards, and to the 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: 2000 2001 ----------- ----------- Short-term items: Allowances for doubtful receivables $ -- $ -- Accrued compensation 46,000 13,000 Accrued penalties 272,000 -- Accrued interest 91,000 -- Long-term items: Depreciation and other 10,000 -- Accrued interest -- 15,000 Income tax credits 97,000 112,000 Net operating loss carryforwards 5,205,000 6,726,000 ----------- ----------- 5,721,000 6,866,000 Less valuation allowances (5,721,000) (6,866,000) ----------- ----------- $ -- $ -- =========== =========== A valuation allowance equal to the full amount of the deferred tax asset has been recorded due to the uncertainty of realization of the deferred tax assets due to the development stage nature and operating loss history of the Company. 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 has federal and Minnesota net operating loss carryforwards of approximately $18,155,000 and $9,330,000, respectively, as of December 31, 2001. These operating losses expire between 2008 and 2021. Net operating loss carryforwards may be subject to the limitations under Section 382 of the Internal Revenue Code due to changes in the equity ownership of the Company. F-23 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE L - RELATED PARTY TRANSACTIONS In addition to the transactions with the Investor discussed in Notes D, E, F and H, a summary of significant related party transactions is as follows: January 7, 1993 (date of inception) Years ended December 31, through ------------------------------- December 31, 1999 2000 2001 2001 -------- -------- -------- -------- Sales to: Stockholder $ 10,000 $ -- $ -- $629,000 Entity partially owned by Company -- -- -- 209,000 Entity related to underwriter and holder of options -- -- -- 244,900 Purchase of optics technology from stockholder -- -- -- 117,000 Purchase of component parts from entity owned by stockholder and director -- -- -- 308,800 Rent, assembly, and design services purchased from affiliate -- -- -- 77,000 Equipment purchased from stockholder -- -- -- 5,000 Payment for development services and other from entity related to underwriter and holder of options 138,600 -- --

138,600 Sale of investment to director 190,000 -- -- 190,000 NOTE M - FAIR VALUES OF FINANCIAL INSTRUMENTS The Statement of Financial Accounting Standards Board No. 107 "Disclosures about Fair Value of Financial Instruments" (SFAS 107) requires disclosure of the estimated fair value of an entity's financial instruments. Such disclosures, which pertain to the Company's financial instruments, do not purport to represent the aggregate net fair value of the Company. At December 31, 2000 and 2001, the carrying value of all material financial instruments, for which it is practicable to estimate the fair value, approximated fair value because of the short maturity of those instruments. F-24 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE N - SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION January 7, 1993 (date of inception) Years ended December 31, through ------------------------------------ December 31, 1999 2000 2001 2001 ---------- ---------- ---------- ---------- Cash paid for: Interest $ -- $ -- $ -- $ 28,544 Noncash Financing Activities: Conversion of short-term notes, accrued interest and penalties into long-term notes and debentures -- -- 4,567,546 4,567,546 Conversion of convertible debentures, bridge notes, and accrued interest into common stock 1,342,000 550,000 513,801 2,584,968 Accretion of preferred stock beneficial conversion feature 285,000 141,000 451,000 877,000 Issuance of Series B preferred stock in exchange for Series A preferred stock and cumulative dividends in arrears, thereon -- -- 281,049 281,049 Issuance of common stock in exchange for Series A preferred stock and cumulative dividends in arrears, thereon -- -- 24,922 24,922 Issuance of preferred stock effected through reduction of debt 100,000 250,000 -- 350,000 Unearned compensation reversal related to employee terminations 42,920 -- -- 227,111 Common stock repurchases effected through a reduction in receivable -- -- -- 170,174 Offset deferred offering costs against proceeds of initial public offering, and other -- -- -- 159,021 F-25 BIO-key International, Inc. (a Corporation in the Development Stage) NOTES TO THE FINANCIAL STATEMENTS December 31, 1999, 2000 and 2001 NOTE O - RECLASSIFICATIONS Certain amounts in the 2000 financial statements have been reclassified to conform to the 2001 presentation. These reclassifications had no effect on the previously reported net loss or stockholders' deficit. NOTE P - EVENTS OCCURRING SUBSEQUENT TO DECEMBER 31, 2001 In February 2002, the Company's shareholders approved amendments to its articles of incorporation which increased the number of authorized shares of common stock from 20,000,000 to 60,000,000 and changed the Company's name from SAC Technologies, Inc. to BIO-key International, Inc. Also in February 2002, the Investor converted $100,000 of the 5% Convertible Debenture into 156,740 shares of the Company's common stock. F-26