

BIO KEY INTERNATIONAL INC  
Form POS AM  
April 05, 2007

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As filed with the Securities and Exchange Commission on April 5, 2007

Registration No. 333-120104

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**POST-EFFECTIVE AMENDMENT NO. 7  
TO  
FORM SB-2**

**REGISTRATION STATEMENT  
UNDER  
THE SECURITIES ACT OF 1933**

**BIO-key International, Inc.**

*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State of incorporation)*

**3577**  
*(Primary Standard Industrial  
Classification Code Number)*

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

**3349 Highway 138, Building D, Suite B, Wall, NJ 07719, (732) 359-1100**  
*(Address and telephone number of registrant's principal executive offices)*

**Michael W. DePasquale**  
**Chief Executive Officer**  
**BIO-key International, Inc., 3349 Highway 138, Building D, Suite B, Wall, NJ 07719, (732) 359-1100**  
*(Name, address and telephone number of agent for service)*

*Copy to:*

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

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

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

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

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

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

### Calculation of Registration Fee

Title of each class of securities to be registered	Number of units to be registered(1)	Proposed maximum aggregate offering price per unit(2)	Proposed maximum aggregate offering price(2)	Amount of registration fee(3)
Common Stock, \$.0001 par value per share, issuable upon conversion of secured convertible term notes	3,740,741 shares(4)	\$0.97	\$3,628,519	\$460
Common Stock, \$.0001 par value per share, issuable upon exercise of warrants	1,122,222 shares(5)	\$0.97	\$1,088,556	\$138
Common Stock, \$.0001 par value per share, issuable upon conversion of subordinated convertible term notes	3,666,666 shares(6)	\$0.97	\$3,556,666	\$449
Common Stock, \$.0001 par value per share, issuable upon exercise of warrants	1,099,997 shares(7)	\$0.97	\$1,066,997	\$136
Common stock, \$.0001 par value per share, issuable upon exercise of warrants	110,000 shares(8)	\$0.97	\$106,700	\$13
Common stock, \$.0001 par value per share, issuable upon exercise of warrants	444,000 shares(9)	\$0.97	\$430,680	\$51

- (1) Pursuant to Rule 416 under the Securities Act, this registration statement also covers an indeterminate number of additional shares of the registrant's common stock as may be issuable upon any stock split, stock dividend or similar transaction.
- (2) Estimated pursuant to Rule 457(c) under the Securities Act solely for the purpose of calculating the registration fee, based upon the average of the high and low sale prices of the registrant's common stock as reported on the OTC Bulletin Board on October 26, 2004, a date within five days of the original filing date of this registration statement.
- (3) The registration fee has been previously paid by the registrant.
- (4) Shares of the registrant's common stock issuable upon conversion of secured convertible term notes issued pursuant to a securities purchase agreement dated as of September 29, 2004.
- (5) Shares of the registrant's common stock issuable upon the exercise of warrants issued pursuant to a securities purchase agreement dated as of September 29, 2004.
- (6) Shares of the registrant's common stock issuable upon conversion of subordinated convertible term notes issued pursuant to a securities purchase agreement dated as of September 29, 2004.
- (7) Shares of the registrant's common stock issuable upon the exercise of warrants issued pursuant to a securities purchase agreement dated as of September 29, 2004.
- (8) Shares of the registrant's common stock issuable upon the exercise of warrants issued from time to time to certain consultants and advisors to the registrant.

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- (9) Shares of the registrant's common stock issuable upon the exercise warrants issued to Jesup & Lamont Securities Corp. and certain of its employees.

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

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**Subject to completion, dated April 5, 2007**

PROSPECTUS

**10,183,626 Shares**  
**BIO-key International, Inc.**

**Common Stock**

We are registering up to 10,183,626 shares of our common stock for offer or sale by the selling security holders named in this prospectus. Of the shares being registered, 7,407,407 shares are issuable upon conversion of convertible term notes issued to certain of the selling security holders and 2,776,219 shares are issuable upon exercise of warrants issued to certain of the selling security holders. The selling security holders may offer or sell all or a portion of their shares publicly or through private transactions at prevailing market prices or at negotiated prices. We will not receive any proceeds from the shares being registered for offer and sale by the selling security holders. We will, however, receive proceeds from the exercise price of certain warrants held by the selling security holders to the extent that such warrants are exercised.

**Investing in our common stock involves a high degree of risk.  
See "Risk Factors" beginning on page 4.**

Our common stock is traded on the OTC Bulletin Board under the symbol "BKYL." The last reported sale price of our common stock on March 30, 2007 was \$0.24 per share.

In addition to the shares being registered for offer or sale by the selling security holders under this prospectus, the registrant is also concurrently conducting three other separate offerings under additional prospectuses, specifically, a separate offering of up to 11,777,191 shares is being concurrently conducted by the registrant by means of a prospectus dated as of July 24, 2006, another separate offering of up to 15,755,500 shares is being concurrently conducted by the registrant by means of a prospectus dated as of July 8, 2004 (as amended), and another separate offering of up to 25,164,046 shares is being concurrently conducted by the registrant by means of a prospectus dated as of December 21, 2006.

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

**April , 2007**

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

**PROSPECTUS SUMMARY**

Effective January 1, 2005, BIO-key International, Inc., a Minnesota corporation ("Old BIO-key") and the original registrant under this Registration Statement, reincorporated as BIO-key International, Inc., a Delaware corporation (the "Company," "BIO-key," "we" or "us"). The reincorporation was effected pursuant to an Agreement and Plan of Merger (the "Merger Agreement"), whereby Old BIO-key was merged with and into the Company, its wholly owned subsidiary, in order to reincorporate in the State of Delaware (the "Reincorporation"). As a result of the Reincorporation, the legal domicile of the registrant is now Delaware.

Pursuant to the Merger Agreement, at the effective time of the Reincorporation: (i) each outstanding share of Common Stock of Old BIO-key, \$0.01 par value per share, was automatically converted into one share of Common Stock, \$0.0001 par value per share, of the Company; (ii) each outstanding share of Series C 7% Convertible Preferred Stock of Old BIO-key, \$0.01 par value per share, was automatically converted into one share of Series A 7% Convertible Preferred Stock, \$0.0001 par value per share, of the Company, with such Series A 7% Convertible Preferred Stock containing substantially identical terms and conditions as the Series C 7% Convertible Preferred Stock of Old BIO-key; (iii) each option to purchase shares of Old BIO-key's Common Stock granted by Old BIO-key under any warrant, stock option plan or similar plan of Old BIO-key outstanding immediately before the Reincorporation was, by virtue of the Merger Agreement and without any action on the part of the holder thereof, converted into and become an option to purchase, upon the same terms and conditions, the same number of shares of the Company's Common Stock at an exercise price per share equal to the exercise price per share thereunder immediately before the Reincorporation; and (iv) each warrant, option or stock option plan of Old BIO-key was assumed by, and continues to be, a warrant, option or plan of the Company. Accordingly, as a result of the Reincorporation, the shareholders of Old BIO-key became shareholders of the Company, and Old BIO-key has been merged out of existence by operation of law. Each certificate representing shares of capital stock of Old BIO-key outstanding immediately before the Reincorporation will, from and after the Reincorporation, be deemed for all corporate purposes to represent the same number of shares of capital stock of the Company.

In accordance with Rule 414(d) under the Securities Act, the Company, as successor issuer to Old BIO-key, has expressly adopted this Registration Statement as its own for all purposes under the Securities Act and the Securities Exchange Act of 1934. The Registration Statement shall hereafter be deemed to relate to that number of shares of the Company's Common Stock to which this Registration Statement originally related.

**About BIO-key International, Inc.**

BIO-key International, Inc., a Delaware corporation (the "Company," "BIO-key," "we," or "us), was founded in 1993 to develop and market proprietary biometric technology and software solutions. Biometric technology is the science of analyzing specific human characteristics which are unique to each individual in order to identify a specific person from a broader population.

On March 30, 2004, BIO-key acquired Public Safety Group, Inc. (PSG), a privately held company that is a leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology is PocketCop , a handheld solution that provides mobile officers, such as detectives who are not typically in their vehicles, a hand-held mobile information software solution.

On September 30, 2004, BIO-key completed a transaction with Aether Systems, Inc. to purchase its Mobile Government Division ("Mobile Government" or "AMG"), a leading provider of wireless data solutions for use by public safety organizations, primarily state, local police, fire and rescue and emergency medical services organizations. The PacketCluster mobile information software is integrated with 50 separate State/NCIC databases, as well as other state, local and federal databases. Its open architecture and its published Application Programming Interface (API) make it easy to interface with

a wide range of information sources. PacketCluster products deliver real-time information in seconds, freeing dispatchers to handle more pressing emergencies.

Effective January 1, 2005, BIO-key International, Inc., a Minnesota corporation ("Old BIO-key"), reincorporated in the State of Delaware. The reincorporation was effected pursuant to an Agreement and Plan of Merger (the "Merger Agreement") whereby Old BIO-key was merged with and into the Company, its wholly owned subsidiary, in order to reincorporate in the State of Delaware (the "Reincorporation"). As a result of the Reincorporation, the legal domicile of the Company is now Delaware.

Pursuant to the Merger Agreement, at the effective time of the Reincorporation: (i) each outstanding share of Common Stock of Old BIO-key, \$0.01 par value per share, was automatically converted into one share of Common Stock, \$0.0001 par value per share, of the Company; (ii) each outstanding share of Series C 7% Convertible Preferred Stock of Old BIO-key, \$0.01 par value per share, was automatically converted into one share of Series A 7% Convertible Preferred Stock, \$0.0001 par value per share, of the Company, with such Series A 7% Convertible Preferred Stock containing substantially identical terms and conditions as the Series C 7% Convertible Preferred Stock of Old BIO-key; (iii) each option to purchase shares of Old BIO-key's Common Stock granted by Old BIO-key under any warrant, stock option plan or similar plan of Old BIO-key outstanding immediately before the Reincorporation was, by virtue of the Merger Agreement and without any action on the part of the holder thereof, converted into and become an option to purchase, upon the same terms and conditions, the same number of shares of the Company's Common Stock at an exercise price per share equal to the exercise price per share thereunder immediately before the Reincorporation; and (iv) each warrant, option or stock option plan of Old BIO-key was assumed by, and continues to be, a warrant, option or plan of the Company. Accordingly, as a result of the Reincorporation, the shareholders of Old BIO-key became shareholders of the Company, and Old BIO-key has been merged out of existence by operation of law. Each certificate representing shares of capital stock of Old BIO-key outstanding immediately before the Reincorporation, is deemed from and after the Reincorporation for all corporate purposes to represent the same number of shares of capital stock of the Company.

As a result of these recent mergers, and as discussed in Note M to the Consolidated Financial Statements included in this prospectus, we have organized the Company into three reporting segments: Law Enforcement, Fire Safety and Biometrics. During 2005, the Company continued to integrate the products, operations and technologies acquired from Public Safety Group, Inc. and Aether Systems, Inc.

We have evolved from a development stage company to a revenue generating company, but we have sustained substantial losses to date. We may need to obtain additional funding to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base, and (ii) provide working capital. Due to, among other factors, our history of losses and limited revenue, our independent auditors have included an explanatory paragraph in their opinion for the year ended December 31, 2005 as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. To the extent that we require such additional financing, no assurance can be given that any form of additional financing will be available on terms acceptable to us, that adequate financing will be obtained to meet our needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or unavailable or we fail to continue to generate meaningful revenue, we may be required to further reduce operating expenses, delay the expansion of operations, or be unable to pursue merger or acquisition candidates.

Our principal executive offices are located at 3349 Highway 138, Building D, Suite B, Wall, NJ 07719 and our telephone number is (732) 359-1100.

### **About the Offering**

This prospectus covers the public resale of up to 10,183,626 shares of our common stock to be sold by the selling security holders identified herein. 3,740,741 shares of our common stock covered by this prospectus are issuable upon conversion of secured convertible term notes in the aggregate principal amount of \$5,050,000, issued to Laurus Master Fund, Ltd. and other institutional and accredited investors pursuant to a Securities Purchase Agreement dated as of September 29, 2004 (the "Senior Purchase Agreement") by and among the Company and such investors. 1,122,222 shares of our common stock covered by this prospectus are issuable upon exercise of warrants issued to the investors party to the Senior Purchase Agreement. 3,666,666 shares of our common stock covered by this prospectus are issuable upon conversion of subordinated convertible term notes in the aggregate principal amount of \$4,950,000, issued to The Shaar Fund Ltd. and other institutional and accredited investors pursuant to a Securities Purchase Agreement dated as of September 29, 2004 (the "Subordinated Purchase Agreement") by and among the Company and such investors. 1,099,997 shares of our common stock covered by this prospectus are issuable upon exercise of warrants issued to the investors party to the Subordinated Purchase Agreement. 10,000 shares of our common stock covered by this prospectus are issuable upon the exercise of a warrant issued by the Company to Kreiger & Prager, LLP on November 26, 2001 in consideration for legal advisory services performed by Kreiger & Prager LLP in connection with the recapitalization of the Company's then outstanding convertible debt and equity securities that occurred on November 26, 2001. 100,000 shares of our common stock covered by this prospectus are issuable upon the exercise of a warrant issued by the Company to The November Group, Ltd. on July 15, 2004 in connection with certain consulting services performed by The November Group, Ltd. with respect to the Company's business development and strategic initiatives. The remaining 444,000 shares of our common stock covered by this prospectus are issuable upon the exercise of warrants issued by the Company to Jesup & Lamont Securities Corp. and certain of its employees on March 31, 2004, which warrants represent a portion of fees earned by Jesup & Lamont Securities Corp. for acting as financial advisor and placement agent in connection with the private placement financing transaction that occurred on March 31, 2004, resulting in approximately \$12,000,000 in aggregate gross proceeds to the Company.



## RISK FACTORS

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

### Business and Financial Risks

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

Due to, among other factors, our history of losses (excluding gains from valuation changes in embedded derivatives) and limited revenue, our independent auditors have included an explanatory paragraph in their opinion for the year ended December 31, 2006 as to the substantial doubt about our ability to continue as a going concern. Our financial statements have been prepared in accordance with accounting principals generally accepted in the United States, which contemplate that we will continue to operate as a going concern. Our financial statements do not contain any adjustments that might result if we are unable to continue as a going concern.

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

As of December 31, 2006, we had negative working capital of approximately \$8,648,000 and an accumulated deficit of approximately \$53,843,000. Since our inception, we have focused almost exclusively on developing our core technologies and, until the fourth quarter of 2004 had not generated any significant revenue. In order to increase revenue, we have developed a direct sales force and anticipate the need to retain additional sales, marketing and technical support personnel and may need to incur substantial expenses. We cannot assure you that we will be able to secure these necessary resources, that a significant market for our technologies will develop or that we will be able to achieve our targeted revenue.

**We have previously identified material weaknesses in our internal control over financial reporting and have historically failed to maintain an effective system of disclosure controls and procedures. If we are unable to maintain an effective system of disclosure controls and procedures, we may not be able to accurately report our financial results or prevent fraud. As a result, current and potential stockholders could lose confidence in our financial reporting; this would harm our business and the trading price of our common stock.**

During the review of the Company's operating results for the year and quarter ended December 31, 2006, our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") determined that, as of that date, our disclosure controls and procedures were effective in providing reasonable assurance that information we are required to disclose in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission rules and forms. Our management reached this conclusion after identifying our system to capture disclosure items, our internal process of review for account reconciliations, our documentation of internal controls and our internal process for preparing our annual report on Form 10-KSB for the fiscal year ended December 31, 2006 as being adequate to provide such assurance.

As previously disclosed, reviews of our March 31, 2005, June 30, 2005, September 30, 2005, March 31, 2006, June 30, 2006 and September 30, 2006 quarterly operating results, as well as our 2005 annual operating results, by our CEO and CFO determined that, as of each such date, our disclosure controls and procedures were not effective to provide reasonable assurance that information we are

required to disclose in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission rules and forms.

In order to ensure that the Company adequately addressed all previous internal control issues, the Company initiated follow-up discussions with its former auditors to better determine what constituted these material weaknesses. During these discussions, the former auditors and the Company identified the following material weaknesses in the Company's internal controls: an inadequate system to capture disclosure items, an inadequate internal process of review for account reconciliations, an inadequate documentation of internal controls and an inadequate internal process around drafting of periodic filings with the Securities and Exchange Commission.

Effective internal control over financial reporting and disclosure controls and procedures are necessary for us to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. We have in the past discovered, as described above, and may in the future discover, areas of our disclosure and internal controls that need improvement. As of December 31, 2006, we believe we have addressed these issues, ensuring that our internal control over financial reporting and disclosure controls and procedures have improved sufficiently for us provide reasonable assurance that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. If, however, we cannot provide reliable financial reports or prevent fraud, our reputation and operating results would be harmed.

We cannot be certain that our efforts to remediate previous material weaknesses in our internal control over financial reporting and the ineffectiveness of our disclosure controls and procedures will continue to be successful or that we will be able to maintain adequate controls over our financial processes and reporting in the future. We have committed substantial resources, including substantial time from our management team's accounting personnel and from external consultants, to implement and integrate into our organization improved disclosure controls and additional procedures generally and to improve systems to report financial information on a timely basis.

Any failure to maintain effective controls, or difficulties encountered in their implementation or in other effective improvement of our internal and disclosure controls could materially harm our operating results or cause us to fail to meet our reporting obligations. If we are unable to adequately establish or improve our internal controls over financial reporting, or if we maintain an ineffective system of disclosure controls and procedures, our financial statements may not accurately reflect the financial condition of the Company, and current and potential future investors may not be able to rely upon our financial statements. Additionally, our external auditors may not be able to issue an unqualified opinion on the effectiveness of our internal controls. Ineffective internal and disclosure controls could also cause investors to lose confidence in our reported financial information, which would likely have a significant negative effect on the trading price of our securities.

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

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

the reliability of biometric solutions

public perception regarding privacy concerns

costs involved in adopting and integrating biometric solutions

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

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

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

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

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

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

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

We market our technology through licensing arrangements with:

Original equipment manufacturers, system integrators and application developers which develop and market products and applications which can then be sold to end users

Companies which distribute goods, services or software applications over the Internet

As a technology licensing company, our success will depend upon the ability of these manufacturers and developers to effectively integrate our technology into products and services which they market and sell. We have no control over these licensees and cannot assure you that they have the financial, marketing or technical resources to successfully develop and distribute products or

applications acceptable to end users or generate any meaningful revenue for us. These third parties may also offer the products of our competitors to end users.

**We derive nearly all of our revenue from government contracts, which are often non-standard, involve competitive bidding, may be subject to cancellation with or without penalty and may produce volatility in earnings and revenue.**

Most of our business involves providing products and services under contracts with U.S. federal, state and local government agencies. Obtaining contracts from government agencies is challenging, and government contracts often include provisions that are not standard in private commercial transactions. For example, government contracts may:

include provisions that allow the government agency to terminate the contract without penalty under some circumstances;

be subject to purchasing decisions of agencies that are subject to political influence;

contain onerous procurement procedures; and

be subject to cancellation if government funding becomes unavailable.

Securing government contracts can be a protracted process involving competitive bidding. In many cases, unsuccessful bidders may challenge contract awards, which can lead to increased costs, delays and possible loss of the contract for the winning bidder.

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

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

A loss of our current Chairman of the Board of Directors or Chief Executive Officer could severely and negatively impact our operations. Our consulting contract with Thomas J. Colatosti, our Chairman of the Board, expired on December 31, 2006, and has not been renewed. Mr. Colatosti continues to assist the Company in the areas of strategic planning and corporate finance. In addition, we have an employment contract with Michael W. DePasquale, our Chief Executive Officer, through March 28, 2008. Although the contract does not prevent him from resigning, it does contain confidentiality and non-compete clauses which are intended to prevent him from working for a competitor within one year after leaving our Company. Our success depends on our ability to attract, train and retain employees with expertise in developing, marketing and selling software solutions. In order to successfully market our technology, we will need to retain additional engineering, technical

support and marketing personnel. The market for such persons remains highly competitive and our limited financial resources will make it more difficult for us to recruit and retain qualified persons.

**We cannot assure you that the 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. In May 2005, the U.S. Patent Office issued us a patent for our Vector Segment fingerprint technology (VST), BIO-key's core biometric analysis and identification technology. We cannot assure you that any additional patents will be 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 assure you that such infringements do not exist or will not exist in the future, particularly as the number of products and competitors in the biometric industry segment grows.

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

Since our inception, we have not generated any significant revenue (other than revenue from acquired businesses) and have experienced substantial losses, including approximately \$7,806,000 during 2006, excluding the impact related to embedded derivative and warrant fair value adjustments, the extinguishment of debt, and the amortization of debt discounts and deferred financing costs. In March 2004, we completed a private placement equity offering that resulted in approximately \$12,000,000 in gross proceeds to the Company and a private placement convertible debt offering in September 2004 that resulted in approximately \$10,000,000 in gross proceeds to the Company (a portion of which was used to finance the acquisition of Aether Mobile Government). In June 2005, we raised approximately \$5,000,000 in gross proceeds through a private placement convertible debt offering, in January 2006 we received approximately \$1,000,000 in another private placement convertible debt offering, and in August 2006 we raised approximately \$2,000,000 in gross proceeds through a private issuance of equity securities, of which \$1,500,000 was received in cash and \$500,000 was paid by an exchange of rights to declared and unpaid dividends.

We need to obtain additional funding to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we need to obtain additional financing through the issuance of debt or equity securities, or to restructure our financial position through similar transactions to what was consummated during 2006. The Company's Series A Convertible Preferred Stock may be redeemable in cash by the stockholders during the second quarter of 2008, if certain stock price performance conditions are not met. This date was deferred from March 3, 2007 to March 3, 2008 by an agreement with the holders of the Series A Shares on March 28, 2007.

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

**We may not achieve profitability with respect to the law enforcement and public safety components of our business if we are unable to maintain, improve and develop the wireless data services we offer.**

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

**Our law enforcement and public safety division depends upon wireless networks owned and controlled by others.**

If we do not have continued access to sufficient capacity on reliable networks, we may be unable to deliver services and our sales could decrease. Our ability to grow and achieve profitability partly depends on our ability to buy sufficient capacity on the networks of wireless carriers such as Verizon Wireless, Bell South Corporation, Metrolcall, Motient and AT&T Wireless and on the reliability and security of their systems. All of our services are delivered using airtime purchased from third parties. We depend on these companies to provide uninterrupted and bug free service and would not be able to satisfy our customers' needs if they failed to provide the required capacity or needed level of service. In addition, our expenses would increase and our profitability could be materially adversely affected if wireless carriers were to increase the prices of their services. Our existing agreements with the wireless carriers generally have one-year terms. Some of these wireless carriers are, or could become, our competitors and if they compete with us they may refuse to provide us with their services.

**New laws and regulations that impact our law enforcement and public safety division could increase our costs or reduce our opportunities to earn revenue.**

We are not currently subject to direct regulation by the Federal Communications Commission or any other governmental agency, other than regulations applicable to businesses in general. However, in the future, we may become subject to regulation by the FCC or another regulatory agency. In addition, the wireless carriers who supply us airtime and certain of our hardware suppliers are subject to regulation by the FCC and regulations that affect them could increase our costs or reduce our ability to continue selling and supporting our services.

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

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

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

As part of our secured convertible debt financing transactions, we granted to Laurus Master Fund, Ltd. and another holder of such secured debt a blanket security interest in all of our assets, including assets of our subsidiary. See the "Management's Discussion and Analysis or Plan of Operation" section of this report. In the event we default in payment on such debt, or any other event of default occurs under the relevant financing documents, and the default is not cured, 120% of the outstanding principal amount of the secured notes, plus accrued interest and fees will accelerate and be due and payable in full. See the "Long Term Obligations" footnote to this report for a list of such potential events of default.

The cash required to pay such accelerated amounts on the secured notes following an event of default would most likely come out of our working capital. As we rely on our working capital for our day to day operations, such a default could have a material adverse effect on our business, operating results, or financial condition to such extent that we are forced to restructure, file for bankruptcy, sell assets or cease operations. In addition, upon an event of default, the holder of the secured debt could foreclose on our assets or exercise any other remedies available to them. If our assets were foreclosed upon, we were forced to file for bankruptcy or cease operations; stockholders may not receive any proceeds from disposition of our assets and may lose their entire investment in our stock.

**Our obligations under our debt securities may adversely affect our ability to enter into potential significant transactions with other parties.**

As a result of our debt financing transactions with Laurus Master Fund, Ltd., the Shaar Fund, Ltd. and other institutional and accredited investors, we incurred significant repayment obligations, and we agreed to certain restrictive covenants. In particular, for so long as 25% of the aggregate principal amount of the convertible term notes remains outstanding, we will need the consent of the holders of such notes before we can take certain actions, including the following:

pay any dividends;

merge, effect a material reorganization, liquidate or dissolve;

materially change the scope of our business; or

create, incur or assume any debt (other than certain trade debt, equipment financings and debt for the purchase of assets in the ordinary course of business).

Accordingly, unless we obtain the noteholders' consent, we may not be able to enter into certain transactions. In addition, in connection with any potential significant transaction (such as a merger, sale of substantially all our assets, joint venture, or similar transaction), it is likely that we would have to pay off such debt obligations and have the applicable security interests released. Although we have the right at any time to prepay our debt obligations, we can only do so upon payment of either 110% or 120% of the then principal balance, plus all other amounts owing under the notes. See the "Long Term Obligations" footnote of this report. Based on an aggregate principal balance of \$4.8 million at December 31, 2006, a complete prepayment would require a cash payment of approximately \$5.3 million. These provisions could have the practical effect of increasing the costs of any potential significant transaction, and restrict our ability to enter into any such transaction.

**Our obligations to the holders of our outstanding preferred stock may further affect our ability to enter into potential significant transactions with other parties.**

We will need to obtain the consent of the holders of a majority of the then outstanding shares of our convertible preferred stock before we can take certain actions, including the following:

a sale or other disposition of any material assets;

an acquisition of a material amount of assets;

engaging in a merger, reorganization or consolidation; or

incur or guaranty any indebtedness in excess of \$50,000.

Accordingly, unless we obtain such consent, we may not be able to enter into certain transactions.

#### **Risks Related To Our Common Stock**

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

As of December 31, 2006, approximately 51,013,900 shares of our common stock were reserved for issuance upon exercise or conversion of the following securities (at conversion prices applicable as at December 31, 2006):

9,623,900 shares upon conversion of outstanding convertible term notes;

18,711,900 shares upon exercise of outstanding stock options and warrants;

1,817,800 shares upon exercise of options available for future grant under our existing option plans; and

20,860,300 shares or more upon conversion of our outstanding shares of Convertible Preferred Stock and cumulative dividends in arrears.

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

**A substantial number of our convertible securities are convertible into shares of common stock at a conversion price of \$.50 per share. Most of these shares are eligible for public resale. The trading price of our common stock and our ability to raise additional financing may be adversely affected by the influx into the market of such a substantial number of shares.**

Our outstanding Series A Convertible Preferred Stock and cumulative dividends in arrears are convertible into 6,165,564 shares of common stock as of December 31, 2006 at a per share conversion price of \$.50. Although many of the shares issuable upon conversion of our Series A Convertible Preferred Stock are eligible for public resale under Securities Exchange Commission Rule 144, we agreed to file a registration statement to cover the public resale of all of these shares. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares and substantially dilute the ownership interests of our existing shareholders. In the event that our stock trades below \$.50 per share, in order to raise additional financing we would likely be required to issue additional shares of common stock or securities convertible into common stock at a purchase or conversion price, as applicable, of less than \$.50 per share. Any issuance of shares at a purchase price of less than \$.50 per share would reduce the conversion price of our Series A Convertible Preferred Shares to such lower price. This would require us to issue additional shares upon conversion of our Series A Shares and further dilute the ownership interests of



our existing shareholders. To the extent these factors are viewed negatively by the market, it may provide an

incentive for persons to execute short sales of our common stock that could adversely affect the trading price of our common stock.

In January 2006, the Company issued Convertible Term Notes in the aggregate principal amount of \$1,000,000 to certain investors. The Convertible Notes subsequently converted into 1,000,000 shares of Series B Convertible Preferred Stock of the Company, which shares and cumulative dividends are convertible into shares of the Common Stock of the Company at a fixed conversion of \$0.50 per share for an aggregate amount of 2,202,136 shares as at December 31, 2006. Although many of the shares issuable upon conversion of our Series B Convertible Preferred Stock are eligible for public resale under Securities Exchange Commission Rule 144, we agreed to file a registration statement to cover the public resale of all of these shares. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares and substantially dilute the ownership interests of our existing shareholders. In the event that our stock trades below \$.50 per share, in order to raise additional financing we would likely be required to issue additional shares of common stock or securities convertible into common stock at a purchase or conversion price, as applicable, of less than \$.50 per share. Any issuance of shares at a purchase price of less than \$.50 per share would reduce the conversion price of our Series B Convertible Preferred Shares to such lower price. This would require us to issue additional shares upon conversion of our Series B Shares and further dilute the ownership interests of our existing shareholders. To the extent these factors are viewed negatively by the market, it may provide an incentive for persons to execute short sales of our common stock that could adversely affect the trading price of our common stock.

In August 2006, certain subordinated terms noted were converted to shares of Series C Convertible Preferred Stock of the Company, which shares and cumulative dividends are convertible into shares of the Common Stock of the Company at an initial fixed conversion of \$0.50 per share for an aggregate amount of 12,492,638 shares as at December 31, 2006. Although many of the shares issuable upon conversion of our Series C Convertible Preferred Stock are eligible for public resale under Securities Exchange Commission Rule 144, we agreed to file a registration statement to cover the public resale of all of these shares. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares and substantially dilute the ownership interests of our existing shareholders. In the event that our stock trades below \$.50 per share, in order to raise additional financing we would likely be required to issue additional shares of common stock or securities convertible into common stock at a purchase or conversion price, as applicable, of less than \$.50 per share. Any issuance of shares at a purchase price of less than \$.50 per share would reduce the conversion price of our Series C Convertible Preferred Shares to such lower price. This would require us to issue additional shares upon conversion of our Series C Shares and further dilute the ownership interests of our existing shareholders. To the extent these factors are viewed negatively by the market, it may provide an incentive for persons to execute short sales of our common stock that could adversely affect the trading price of our common stock.

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

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

sale. These regulations have the effect of limiting the trading activity of our common stock and reducing the liquidity of an investment in our common stock.

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

We have never declared or paid a dividend on our common stock. In addition, the terms of our outstanding Convertible Preferred Shares preclude us from declaring or paying a dividend on our common stock unless a dividend is also declared or paid, as applicable, on our Convertible Preferred Shares. We intend to retain earnings, if any, for use in the operation and expansion of our business and, therefore, do not anticipate paying any dividends on our common stock in the foreseeable future.

**The trading price of our common stock may be volatile.**

The trading price of our shares has from time to time fluctuated widely and in the future may be subject to similar fluctuations. The trading price may be affected by a number of factors including the risk factors set forth in this 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 cannot assure you that any of these firms will continue to serve as market makers or have the financial capability to stabilize or support our common stock. A reduction in the number of market makers or the financial capability of any of these market makers could also result in a decrease in the trading volume of and price of our shares. In recent years broad stock market indices, in general, and the securities of technology companies, in particular, have experienced substantial price fluctuations. Such broad market fluctuations may adversely affect the future-trading price of our common stock.

**The selling security holders intend to sell their shares of common stock in the market, which sales may cause our stock price to decline.**

The selling stockholders named in this prospectus intend to sell in the public market 10,183,626 shares of our common stock being registered in this offering. That means that up to 10,183,626 shares may be sold pursuant to this registration statement. Such sales may cause our stock price to decline. Our officers and directors and those shareholders who are significant shareholders as defined by the Securities and Exchange Commission will continue to be subject to the provisions of various insider trading and Rule 144 regulations.

**We are subject to compliance with federal and state securities law, which exposes us to potential liabilities, including potential rescission rights. The original resale registration statement of which this prospectus was a part included shares of our common stock issuable upon conversion of certain interest and fee obligations owed to the selling securityholders under our outstanding convertible term notes. The inclusion of such interest and fee shares may have violated Section 5 of the Securities Act of 1933.**

We have periodically offered and sold our securities to investors pursuant to certain exemptions from the registration requirements of the Securities Act of 1933, as well as those of various state securities laws. The shares of our common stock being registered for resale in this offering are issuable upon conversion of our senior and subordinated convertible term notes originally issued and sold on September 29, 2004 to the selling securityholders named in this prospectus, which notes were issued and sold based on exemptions from those registration requirements. The original resale registration statement of which this prospectus was a part included 1,539,526 shares of our common stock issuable upon conversion of certain interest and fee obligations owed to the selling securityholders under those convertible term notes. The selling securityholders were permitted to accept such shares of our common stock in lieu of cash as payment for the interest and fees that would accrue under those

convertible term notes subsequent to the initial filing date of the registration statement. After the effectiveness date of the registration statement, the Company removed all of the interest and fee shares from the registration statement. Including such interest and fee shares in the original resale registration statement before the potential recipients had made their investment decision to purchase those shares, however, may be deemed to have been a violation of Section 5 of the Securities Act of 1933. If so, the selling securityholders could seek to rescind their purchases of the convertible term notes if they so desired. If investors were successful in seeking rescission, we would face severe financial demands that could adversely affect our business and operations.

#### **FORWARD-LOOKING STATEMENTS**

All statements other than statements of historical facts contained in this prospectus, including statements regarding our future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words "anticipate," "believe," "estimate," "will," "may," "future," "plan," "intend" and "expect" and similar expressions generally identify forward-looking statements. Although we believe that our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure that they will be achieved. Actual results may differ materially due to a number of factors. Many of these factors are set forth in the "RISK FACTORS" section of this prospectus. Actual results may differ materially from the forward-looking statements contained in this prospectus. These factors are not intended to represent a complete list of the general or specific factors that may affect us. It should be recognized that other factors, including general economic factors and business strategies, may be significant, presently or in the future. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

#### **USE OF PROCEEDS**

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

**MARKET FOR COMMON STOCK AND RELATED STOCKHOLDER MATTERS**

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

<b>2006:</b>	<b>High</b>	<b>Low</b>
Quarter ended December 31, 2006	\$ 0.53	\$ 0.32
Quarter ended September 30, 2006	0.49	0.39
Quarter ended June 30, 2006	0.67	0.40
Quarter ended March 31, 2006	0.94	0.58
<b>2005:</b>	<b>High</b>	<b>Low</b>
Quarter ended December 31, 2005	\$ 0.81	\$ 0.50
Quarter ended September 30, 2005	1.21	0.74
Quarter ended June 30, 2005	1.39	0.99
Quarter ended March 31, 2005	1.63	1.13
<b>2004:</b>	<b>High</b>	<b>Low</b>
Quarter ended December 31, 2004	\$ 1.61	\$ 0.74
Quarter ended September 30, 2004	1.43	0.60
Quarter ended June 30, 2004	3.00	1.26
Quarter ended March 31, 2004	1.85	1.03
<b>2003:</b>	<b>High</b>	<b>Low</b>
Quarter ended December 31, 2003	\$ 1.40	\$ 0.53
Quarter ended September 30, 2003	0.59	0.38
Quarter ended June 30, 2003	0.64	0.30
Quarter ended March 31, 2003	0.73	0.35

The last price of our common stock as reported on the OTC Bulletin Board on March 30, 2007 was \$0.24 per share.

**Holders**

As of March 1, 2007, the number of stockholders of record of our common stock was 191.

**Dividends**

We have not paid any cash dividends on our common stock to date, and have no intention of paying any cash dividends on our common stock in the foreseeable future. The terms of our outstanding Convertible Preferred Stock preclude us from declaring or paying a dividend on our common stock unless a dividend is also declared or paid, as applicable, on our Convertible Preferred Stock. The declaration and payment of dividends on our common stock is also subject to the discretion of our Board of Directors and certain limitations imposed under the Delaware General Corporation Law. The timing, amount and form of dividends, if any, will depend on, among other things, our results of operations, financial condition, cash requirements and other factors deemed relevant by our Board of Directors.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

This Management's Discussion and Analysis or 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 us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth in the section captioned "RISK FACTORS" in Item 1 and elsewhere in this Report. The following should be read in conjunction with our audited financial statements included elsewhere herein.

The following Management's Discussion and Analysis or Plan of Operation ("MD&A") is intended to help you understand BIO-key International (the "Company", "we", "us" or "our"). MD&A is provided as a supplement to and should be read in conjunction with our financial statements and the accompanying notes. The results included in this MD&A have been restated. Our MD&A includes the following sections:

OVERVIEW provides a description of our business, the major items that affected our business, and how we analyze our business. It then provides an analysis of our overall 2006 performance and a description of the significant events impacting 2006 and thereafter.

RESULTS OF OPERATIONS provides an analysis of the consolidated and segment results of operations for 2006 compared to 2005.

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

RESTATEMENT provides a description and reconciliation of the restatement. For additional information, see Item 8, Financial Statements and Supplementary Data, Note B, Restatement of Previously Issued Financial Statements.

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

RECENT ACCOUNTING STANDARDS by reference to Note 1 to the Consolidated Financial Statements provides a description of accounting standards which we have not yet been required to implement and may be applicable to our operations, as well as those significant accounting standards which were adopted during 2006.

### OVERVIEW

#### Our Business

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

We pioneered the development of automated, finger identification technology that can be used without the aid of non-automated methods of identification such as a personal identification, password, token, smart card, ID card, credit card, passport, driver's license or other form of possession or knowledge based identification. This advanced BIO-key identification technology improves both the accuracy and speed of finger-based biometrics and is the only finger identification algorithm that has been certified by the International Computer Security Association (ICSA).

Since our inception in 1993, we have spent substantial time and effort in completing the development of what we believe is the most discriminating and effective finger biometric technology available. During the past two years, our focus has shifted to marketing and selling this technology and completing strategic acquisitions that can help us leverage our capability to deliver identification solutions. We have built a direct sale force of professionals with substantial experience in selling technology solutions to government and corporate customers.

On March 30, 2004, we acquired all of the outstanding capital stock of Public Safety Group, Inc., a privately-held provider of wireless solutions for law enforcement and public safety markets based in Winter Park, Florida, in exchange for an aggregate of 2,422,108 shares of our common stock, \$500,000 in cash, and our assumption of \$600,000 in aggregate net liabilities of PSG. The acquisition was completed pursuant to the terms of an agreement and plan of merger by and among the Company, BIO-key Acquisition Corp., a wholly-owned subsidiary of the Company, PSG and all of the shareholders of PSG. As a result of this transaction, PSG became a wholly-owned subsidiary of the Company.

On September 30, 2004, we completed our acquisition of the Mobile Government Division from Aether Systems Inc. Pursuant to the Asset Purchase Agreement dated as of August 16, 2004 by and among the Company, Aether, Cerulean Technology, Inc. and SunPro, Inc., the Company paid Aether a purchase price of \$10,000,000 in cash, subject to post-closing adjustments to reflect changes in Aether Mobile Government's working capital and cash flows since June 30, 2004. Post-closing working capital adjustments resulted in an additional payment by the Company of \$341,878 in December 2004. In connection with this acquisition, the Company issued a subordinated secured promissory note to Aether in the face amount of \$6,884,588 (the "Aether Note"). The Aether Note evidences a contingent reimbursement obligation of the Company to Aether and a surety fee payable by the Company to Aether, in each case with respect to a letter of credit maintained by Aether for the Company's benefit in connection with the acquisition. The Company's obligations under the Aether Note are secured by a security interest granted to Aether in all or substantially all of the Company's assets, subordinate to the security interest described in the "Long-Term Obligations" footnote to this annual report.

The Mobile Government Division provides wireless data solutions for use by public safety organizations, primarily state and local police, fire and rescue and emergency medical services organizations that enable such organizations to access law enforcement databases to validate identities and obtain suspect information. Its public safety solutions are integrated into fifty (50) different state databases, as well as local and federal databases, and its products deliver real-time information in seconds, without the need for human dispatchers or other resources.

## **INTRODUCTION**

During 2004 and 2005, the Company integrated the products, operations and technology acquired from the Public Safety Group in March 2004 and Aether Systems in September 2004, in an effort to leverage new business opportunities. In the fourth quarter of 2005, the Company restructured its operations into three business segments: Biometrics, Law Enforcement and Fire Safety. Each segment is headed by a General Manager and organized to quickly respond to market needs as well as to drive down costs to achieve profitability. Management believes that this initiative has led to increased opportunities in 2006 as the General Managers develop their organizations. A detailed analysis of each segment can be found below.

**RESULTS OF OPERATIONS***Consolidated Results of Operations**Two Year % trend*

	Years ended December 31,	
	2006	2005
	(As Restated)	
<b>Revenues</b>		
Services	72%	76%
License fees and other	28%	24%
	<u>100%</u>	<u>100%</u>
<b>Costs and other expenses</b>		
Cost of services	17%	20%
Cost of license fees and other	5%	7%
	<u>22%</u>	<u>27%</u>
Gross Profit	<u>78%</u>	<u>73%</u>
<b>Operating expenses</b>		
Selling, general and administrative	68%	83%
Research, development and engineering	43%	48%
	<u>111%</u>	<u>131%</u>
Operating loss	(33)%	(58)%
<b>Other income (deductions)</b>		
Total other income (deductions)	(40)%	32%
<b>NET INCOME (LOSS)</b>	<u>(73)%</u>	<u>(26)%</u>

In the fourth quarter of fiscal year 2005, the Company's consolidated operations were divided into three segments: Law, Fire and Biometric. Prior to this segmentation of the business management evaluated the business as one consolidated operation. For presentation and comparability purposes the allocation of costs between segments for prior periods have been estimated.

The Company evaluates performance and allocates resources based on revenues and operating income (loss). Operating income (loss) for each segment includes selling, general and administrative expenses directly attributable to the segment in addition to those allocated as a percentage based on the segments' revenues and other factors. The segmentation of operating income as noted above and detailed below reflects how management now evaluates its business. Assets for the Company are



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commingled and are related to all operating segments. Management does not evaluate or identify the operating assets of the segments separately.

	2006-2005			
	2006	2005	\$ Chg	% Chg
<b>Revenues</b>				
<b>Law Enforcement</b>				
Service	\$ 8,069,005	\$ 7,886,000	\$ 183,005	2%
License & other	2,357,112	2,638,938	(281,826)	(11)%
	<u>10,426,117</u>	<u>10,524,938</u>	<u>(98,821)</u>	<u>(1)%</u>
<b>Fire Safety</b>				
Service	2,801,513	2,814,616	(13,103)	0%
License & other	1,104,941	406,470	698,471	172%
	<u>3,906,454</u>	<u>3,221,086</u>	<u>685,368</u>	<u>21%</u>
<b>Biometrics</b>				
Service	79,377	161,033	(81,656)	(51)%
License & other	781,677	319,038	462,639	145%
	<u>861,054</u>	<u>480,071</u>	<u>380,983</u>	<u>79%</u>
<i>Total Revenue</i>	<u>\$ 15,193,625</u>	<u>\$ 14,226,095</u>	<u>\$ 967,530</u>	<u>7%</u>
<b>Cost of goods sold</b>				
<b>Law Enforcement</b>				
Service	\$ 1,629,627	\$ 2,260,845	\$ (631,218)	(28)%
License & other	482,794	679,170	(196,376)	(29)%
	<u>2,112,421</u>	<u>2,940,015</u>	<u>(827,594)</u>	<u>(28)%</u>
<b>Fire Safety</b>				
Service	950,503	602,317	348,186	58%
License & other	81,626	165,074	(83,448)	(51)%
	<u>1,032,129</u>	<u>767,391</u>	<u>264,738</u>	<u>34%</u>
<b>Biometrics</b>				
Service	93,693	42,980	50,713	118%
License & other	158,463	93,247	65,216	70%
	<u>252,156</u>	<u>136,227</u>	<u>115,929</u>	<u>85%</u>
<i>Total COGS</i>	<u>\$ 3,396,706</u>	<u>\$ 3,843,633</u>	<u>\$ (446,927)</u>	<u>(12)%</u>

**Revenues**

*Law Enforcement*

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Service revenue for the segment for the year ended December 31, 2006 included approximately \$1,409,000 from a long-term project that the Company had participated in as a subcontractor. The amount resulted from a cash payment of approximately \$571,000 along with approximately \$838,000 of revenue that was previously deferred until evidence of full acceptance by the end user was received by the Company. That increase was offset by a reduction in revenue from other longer-term project work that was present in 2005, as the Company moves to more of a license-based model.

*Fire Safety*

The increase in revenue for this segment over the prior year was driven by increased license sales, including a full year of sales of the Fire RMS product that was introduced mid-year 2005. Sales in 2006 also included increased sales through one of the Company's channel partners. Management expects this increase in market presence to continue, and will continue to focus resources on this segment.

*Biometrics*

A substantial portion of the revenue for the year ended December 31, 2006, was attributable to a large license order in Q1 2006 from a new customer. However, revenue in this segment continues to be inconsistent and unpredictable as the market for the Biometrics' products continues to develop slowly.

*Costs of goods sold**Law Enforcement*

The decrease in Service Costs for the 2006 year were attributable to a reduction in personnel and related expenses that were needed in connection with several long term projects that were completed in 2005.

The cost of License and Other Revenues derived primarily from product sales for which we are required to pay a royalty. The decrease in cost is primarily driven by the sales mix and is solely dependent specifically on what products were sold.

*Fire Safety*

Services costs have increased over the prior year primarily from the addition of dedicated support and implementation staff to support the increasing customer base in the Fire Safety segment.

License and other costs are attributable primarily to revenues derived from product sales for which we are required to pay a royalty. The decrease in cost is primarily driven by the sales volume in addition to product mix. These costs are solely dependent specifically on what products were sold.

*Biometrics*

The increase in Service costs are the result of an increased allocation of a customer support person's time to the segment to support the larger customer base in 2006.

License and other costs are primarily related to the hardware costs related to sales of biometric fingerprint readers. The change in cost of goods sold is directly attributable to the product mix between types of readers sold and the volume of readers sold.

*Selling, general and administrative*

	2006	2005	2006-2005	
			\$ Chg	% Chg
<b>Law Enforcement</b>	\$ 4,944,737	\$ 7,471,524	\$ (2,526,787)	(34)%
<b>Fire Safety</b>	3,037,050	2,802,220	234,830	8%
<b>Biometrics</b>	2,329,230	1,550,865	778,365	50%
<b>Total</b>	\$ 10,311,017	\$ 11,824,609	\$ (1,513,592)	(13)%

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As discussed previously, the Company restructured its operations into three business segments: Biometrics, Law Enforcement and Fire Safety in the fourth quarter of 2005. For 2005, SG&A costs were allocated to the segments based on several factors including management's estimates and percentage of revenue. For 2006, sales expenses were a direct cost to the segment, with G&A costs allocated between business segments on fixed percentages which had been established by management during the budgeting process.

The overall decline in total SG&A costs for the year ended December 31, 2006 as compared to the 2005 year, is primarily attributable to the continued focus of management on the cost reduction initiatives which commenced during the fourth quarter of 2005. Significant reductions in selling expenses (including personnel costs and commissions) were partially offset by additional costs related to reporting and compliance that the Company has experienced due to the restatements of our previously filed financial statements, and amendments of our previously filed registration statements.

Management believes the appropriate resources are in place to support its strategic goals, but also continues to analyze the expense structure to explore ways in which to further reduce costs, through synergies and increased system efficiencies.

### *Research, development and engineering*

	2006-2005			
	2006	2005	\$ Chg	% Chg
<b>Law Enforcement</b>	\$ 3,812,117	\$ 3,931,265	\$ (119,148)	(3)%
<b>Fire Safety</b>	1,304,874	1,207,263	97,611	8%
<b>Biometrics</b>	1,397,362	1,707,507	(310,145)	(18)%
<b>Total</b>	\$ 6,514,353	\$ 6,846,035	\$ (331,682)	(5)%

The decrease in total R&D expenses in 2006 as compared to 2005 is primarily due to lower personnel and related expenses. Management believes the appropriate resources are in place to support its strategic goals and expenses should remain relatively flat in total dollars.

#### *Law Enforcement*

R & D costs have decreased slightly for the year ended December 31, 2006 as compared to 2005, primarily due to staff and cost structure reductions undertaken by management in the fourth quarter of 2005.

#### *Fire Safety*

R & D costs have increased slightly for the year ended December 31, 2006 as compared to 2005, as the Company added additional resources in this segment to support the increased demand for its Fire segment products

#### *Biometrics*

R & D costs have decreased for the year ended December 31, 2006, as compared to 2005, due to lower personnel costs. As the Company continues to develop further integration of its Biometric software solutions in other products with in Company it has required less direct resources in the segment.

*Other income and expense*

	2006	2005	2006-2005	
			\$ Chg	% Chg
	(As Restated)			
Interest income	\$	\$ 35,958	\$ (35,958)	(100)%
Interest expense	(5,730,712)	(4,521,344)	(1,209,368)	27%
Derivative and warrant fair value adjustments	7,542,666	9,154,951	(1,612,285)	(18)%
Gain (loss) on sale of marketable securities		(20,000)	20,000	(100)%
Loss on extinguishment of debt	(7,815,717)		(7,815,717)	n/a
Other income (expense)	(48,637)	(34,767)	(13,870)	40%
	<u>\$ (6,052,400)</u>	<u>\$ 4,614,798</u>	<u>\$ (10,667,198)</u>	<u>(231)%</u>

For the year ended December 31, 2006, consolidated interest expense increased approximately \$1,209,000 or 27% as compared to the 2005 year. Interest expense includes amounts accrued on senior and subordinated convertible debt, and on the letter of credit arrangement, as well for the amortization of debt discounts, and deferred financing costs. The increase in interest expense during 2006 was primarily related to the default interest and the liquidating damages provisions enforced with respect to the convertible debt and preferred stock instruments. These provisions were triggered due to the Company breaching certain registration right agreement clauses during the year. The increase in interest expense was offset by the exchange of certain debt instruments to preferred stock in August 2006.

For the year ended December 31, 2006, derivative and warrant fair value adjustments decreased when compared to the 2005 year, due to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt issued in 2004 and 2005, as well as changes in the fair market value of derivatives recorded as a result of financings in 2006. The changes represent non-cash income and expense charges to the statement of operations. The fair value of the derivatives will fluctuate based on; our stock price on the valuation date, the debt conversion price, the volatility of our stock price over a period of time, changes in the value of the risk free interest rate, and the time to maturity of the outstanding debt and the time to conversion or redemption of preferred stock at different points in time.

As mentioned in Note L and Note Q to the consolidated financial statements, the balance of the embedded derivatives, warrants, and unamortized discounts with respect to the 2004 and 2005 financings were extinguished as part of the January and August 2006 debt restructurings. These events precipitated the recording of the above "loss on extinguishment of debt," during the year ended December 31, 2006. There was no such event during the year ended December 31, 2005.

**LIQUIDITY AND CAPITAL RESOURCES****OPERATING ACTIVITIES OVERVIEW**

The net cash used in operating activities during 2006 was \$3,551,455, as compared to \$4,513,497 in 2005. Some of the major drivers of this change are discussed in more detail below. The Company's income statement includes five non-cash items which made the most significant contributions to the net cash used in operating activities in 2006 and 2005.

The Company issued notes in 2004 and 2005 and preferred stock in 2006, all of which contained embedded derivatives, and associated warrants. In 2006 and 2005, the Company recognized gains of approximately \$7,543,000 and \$9,155,000 respectively, related to the decrease in value of the derivatives and associated warrants. The decrease in value is driven mainly by the decline in value of the underlying BIO-key stock.

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The Company recorded approximately \$7,816,000 and \$0 of charges in 2006 and 2005, respectively, for the non-cash expense related to the extinguishment of debt as a result of its January and August 2006 refinancings.

A debt discount was identified when the 2004 and 2005 notes were initially recorded to reflect the fair market value of the embedded derivatives and warrants associated with the debt. The discount is amortized using the effective interest method into earnings over the life of the related debt. In 2006 and 2005, the company recorded non-cash interest expense related to the amortization of the debt discount of approximately \$2,774,000 and \$2,098,000 respectively.

The company recorded approximately \$864,000 and \$1,324,000 of charges in 2006 and 2005, respectively, for the non-cash expense of amortizing intangible assets.

The Company recorded approximately \$727,000 and \$664,000 of charges in 2006 and 2005, respectively, for the non-cash expense of issuing options and warrants to non employees for services.

For the years ended December 31, 2006 and 2005, the Company reported positive cash flows related to a decrease in costs and earnings in excess of billings on uncompleted contracts of approximately \$3,106,000 and \$2,469,000, respectively. Costs and earnings in excess of billings on uncompleted contracts represent services which have been performed on long term contracts but have not been invoiced at year end due to milestones contained within the contracts. During 2006 and 2005, the Company was able to bill the customers due to the fact the milestones had been reached. A corresponding increase of approximately \$1,336,000 and decrease of approximately 345,000 in accounts receivable was experienced during 2006 and 2005 respectively, which indicated the majority of amounts transferred from the costs and earnings in excess of billings on uncompleted contracts during the period were collected by the Company.

The Company also experienced a positive cash flow from an increase of approximately \$613,000 and \$1,192,000 in deferred revenue from 2006 and 2005 respectively, due to customers who had purchased and paid for maintenance agreements which the company had to earn typically over a one year period.

The overall major drivers in operating cash flow are the current operating costs which are greater than the current revenues. The company has experienced improvements related to the ratio of operating expenses to revenues and expects this trend to continue to improve until such time as the Company is able to generate sustained profitability.

### ***FINANCING ACTIVITIES OVERVIEW***

#### ***Financing Activities***

##### **2005 Senior and Subordinate Term Notes**

On June 8, 2005, we entered into a Securities Purchase Agreement (the "Senior Purchase Agreement") with an institutional investor. Under the Senior Purchase Agreement, the Company issued a Secured Convertible Term Note (the "Senior Convertible Note") in the aggregate principal amount of \$2,000,000, convertible into Common Stock of the Company in certain circumstances at \$0.85 per share, and issued a warrant (the "Senior Warrant") to purchase an aggregate of 444,444 shares of the Common Stock at a per share exercise price of \$1.00. The aggregate consideration received by the Company, net of all fees and expenses, for the Senior Convertible Note and the Senior Warrant was approximately \$1,841,000. The proceeds from this transaction were used for working capital purposes. The Company's obligations under the Senior Purchase Agreement and the Senior Convertible Notes are secured by a security interest in all or substantially all of the Company's assets.

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Under the terms of the Senior Convertible Note, we are required to make monthly payments of accrued interest only beginning on July 1, 2005. In addition, the Senior Convertible Note provides for monthly payments of principal in equal 1/32 increments thereof, plus accrued interest, commencing October 1, 2005.

We entered into a Securities Purchase Agreement, effective as of May 31, 2005, (the "Subordinated Purchase Agreement") with existing shareholders of the Company and other accredited investors (collectively, the "Subordinated Investors"). Under the Subordinated Purchase Agreement, the Company issued Convertible Term Notes (the "Subordinated Convertible Notes") in the aggregate principal amount of \$2,794,723, respectively convertible into Common Stock of the Company in certain circumstances at \$0.70 per share, and issued warrants (the "Subordinated Warrants") to purchase an aggregate of 828,066 shares of the Common Stock at a per share exercise price of \$1.00. The aggregate consideration received by the Company, net of all fees and expenses, for such Subordinated Convertible Notes and Subordinated Warrants was approximately \$2,411,000. The proceeds from this transaction were used for working capital purposes. The Subordinated Convertible Notes were issued at a purchase price equal to \$900 for each \$1,000 of principal amount of the Note.

Certain Subordinated Investors purchased additional Subordinated Convertible Notes in the aggregate principal amount of \$450,000 and received additional Subordinated Warrants to purchase an aggregate of 133,333 shares of Common Stock at a per share exercise price of \$1.00. The aggregate consideration received by the Company net of all fees and expenses for such Subordinated Convertible Notes and Subordinated Warrants was \$404,500, which was paid by the Subordinated Investors on July 8, 2005.

Under the terms of the Subordinated Convertible Notes, we are required to make quarterly payments of accrued interest only beginning on September 1, 2005. In addition, the Subordinated Convertible Notes provide for quarterly payments of principal in equal increments thereof, plus accrued interest, commencing September 1, 2006 through May 31, 2008, which payments may be made in shares of common stock at the option of each note holder.

### **2005 Amendment and Waivers**

The Company entered into an Amendment and Waiver with Laurus, dated as of August 31, 2005, pursuant to which the Company was permitted to defer the payment of the monthly principal amounts due and payable for the months of September, October, November and December 2005 under both (a) the Secured Convertible Term Note in the original principal amount of \$5,000,000 issued by the Company to Laurus on September 29, 2004 (the "September 2004 Note"), and (b) the Secured Convertible Term Note in the original principal amount of \$2,000,000 issued by the Company to Laurus on June 8, 2005 (the "June 2005 Note"), such aggregate deferred principal amounts being equal to \$625,000 and \$187,500, respectively. The deferred principal amount under the September 2004 Note is now due on September 29, 2007, the maturity date of that note, and will be paid at the same time the final payments due with respect to that note upon maturity. The deferred principal amount under the June 2005 Note is now due on June 7, 2008, the maturity date of that note, and will be paid at the same time the final payments due with respect to that note upon maturity. The Company will remain obligated to pay all monthly interest amounts under these notes as they are currently due.

The Company also entered into Amendment and Waivers, dated as of August 31, 2005, pursuant to which certain Subordinated Investors allowed the Company to defer the payment of the monthly principal amounts due and payable for the months of September, October, November and December 2005 under the Convertible Term Notes in the aggregate original principal amount of \$2,800,000 issued by the Company to the Subordinated Investors on September 29, 2004 (the "Subordinated Notes"), such aggregate deferred principal amount being equal to \$350,004. The deferred principal amount under each Subordinated Note is now due on September 29, 2007, the

maturity date of each such note, and will be paid at the same time the final payments due with respect to each such note upon maturity. The Company will remain obligated to pay all monthly interest amounts under these notes as they are currently due.

#### **2006 Amendment and Waiver**

The Company entered into an Amendment No. 1 to its Subordinated Secured Promissory Note, dated as of January 23, 2006, with Aether Systems, Inc. Pursuant to the Aether Note Amendment, the Subordinated Secured Promissory Note issued by the Company to Aether on September 30, 2004 in the aggregate maximum principal amount of \$6,884,588 was amended to increase such aggregate maximum principal amount to \$7,884,588. The Aether Note evidences a contingent reimbursement obligation of the Company to Aether and a surety fee payable by the Company to Aether, in each case with respect to a letter of credit maintained by Aether for the Company's benefit in connection with the Company's acquisition of the Mobile Government Division of Aether on September 30, 2004. The Company's obligations under the Aether Note remain secured by a security interest granted to Aether in all or substantially all of the Company's assets subordinated to the security interest of Laurus pursuant to the 2004 and 2005 Senior Notes.

The Company entered into a Securities Purchase Agreement, effective as of January 23, 2006, with The Shaar Fund, Ltd., Longview Fund, L.P. and Longview Special Finance. Under the Securities Purchase Agreement, the Company issued to the Purchasers Convertible Term Notes in the aggregate principal amount of \$1,000,000. The Convertible Notes converted into shares of the Series B Preferred Stock of the Company, which shares are convertible into shares of the Common Stock of the Company at an initial fixed conversion price of \$0.70 per share.

Effective as of January 23, 2006, BIO-key International, Inc. entered into an Amendment and Waiver with Laurus Master Fund Ltd. in connection with the Secured Convertible Notes currently held by Laurus. Under the Secured Notes Amendment and Waiver, the Secured Notes issued by the Company to Laurus on September 29, 2004 in the aggregate principal amount of \$5,000,000 and on June 7, 2008 in the aggregate principal amount of \$2,000,000 were amended as follows: (i) the maturity date of the September 2004 Note was extended to January 1, 2008; (ii) the maturity date of the June 2005 Note was extended to December 1, 2008, and (iii) the fixed conversion price under each of the Secured Notes was reset from \$1.35 to \$0.85 per share. In addition, the exercise price of all warrants to purchase Common Stock of the Company held by Laurus was reset to \$1.00 per share.

Effective as of January 23, 2006, the Company also entered into an Amendment and Waiver with certain holders of its Subordinated Convertible Promissory Notes. Under the Subordinated Notes Amendment and Waiver, the Subordinated Notes issued by the Company on September 29, 2004 in the aggregate principal amount of \$5,288,221 and on May 31, 2005 in the aggregate principal amount of \$3,244,723 were amended as follows: (i) the maturity dates were extended from September 29, 2007 and May 31, 2008, respectively, to January 1, 2009; (ii) the interest rate was fixed at fifteen percent (15%); (iii) all principal amounts are due at the maturity date and shall be paid in shares of Common Stock priced at \$0.70 per share if the average closing price of the Common Stock for the thirty (30) trading days immediately preceding the maturity date is greater than \$1.10; (iv) interest shall be paid, at the Company's election, in cash or shares of Common Stock, with the Common Stock priced at the average closing price of the Common Stock for the ten (10) trading days immediately preceding the repayment date; and (v) the currently applicable fixed conversion price was amended to \$0.70 per share. In addition, the exercise price of all warrants to purchase Common Stock held by the Subordinated Note Holders that currently have an exercise price greater than \$1.00 per share was reset to \$1.00 per share. In connection with this financing, we also reduced the conversion price of the Series A Convertible Preferred shares held by the Shaar Fund Ltd. to \$0.70 per share.



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Effective as of August 10, 2006, the Company also entered into an Amendment and Waiver with Laurus in connection with the holder of its Secured Convertible Notes currently held by Laurus. Under the Amendment and Waiver, the September 2004 Note and June 2005 Note were amended as follows: (i) the principal amounts due and payable under the 2004 Note and the 2005 Note for the months of August and September 2006, respectively, shall be paid in shares of the Company's Common Stock priced at \$0.50 per share; and (ii) the principal amount due and payable under the 2004 Note for the months of October, November and December 2006 is deferred until January 1, 2008, the final maturity date of the 2004 Note, and the principal amount due and payable under the 2005 Note for the months of October, November and December 2006 is deferred until December 1, 2008, the final maturity date of the 2005 Note. Pursuant to this Amendment and Waiver, the Company issued 150,000 shares of its common stock to Laurus as consideration for the principal payment deferral. In connection with this financing, the Company reduced the conversion price under each of the September 2004 Note and June 2005 Note to \$0.50 per share.

Effective as of August 10, 2006, the Company also entered into a Securities Exchange Agreement with certain holders of its Subordinated Convertible Promissory Notes. Under the Securities Exchange Agreement, certain Subordinated Notes issued by the Company on September 29, 2004 in the aggregate principal amount of \$5,288,221 and on May 31, 2005 in the aggregate principal amount of \$3,244,723 were amended as follows: (i) the aggregate principal amount outstanding under the Notes, plus accrued and unpaid interest, and liquidated damages were exchanged for shares of Series C Convertible Preferred Stock; and (ii) in addition, the exercise price of all warrants held by Subordinated Note Holders dated May 31, 2005 and January 23, 2006, to purchase Common Stock of the Company was reset to \$0.50 per share. In connection with this financing, the Company also reduced the conversion price of the Series A and Series B Convertible Preferred shares to \$0.50 per share.

The Company entered into (i) a Securities Purchase Agreement (the "Trellus Securities Purchase Agreement"), dated as of August 10, 2006, with Trellus Partners, L.P. ("Trellus") and (ii) a Securities Purchase Agreement (the "Shaar Securities Purchase Agreement"), dated as of August 10, 2006, with Shaar. Under the Trellus Securities Purchase Agreement, the Company (i) issued and sold 3,000,000 shares of its Common Stock (the "Trellus Shares") to Trellus, at a purchase price of \$0.50 per share, for an aggregate purchase price of \$1,500,000 and (ii) issued a warrant to Trellus (the "Trellus Warrant") to purchase up to an aggregate of 400,000 shares of the Company's Common Stock at an exercise price of \$0.75 per share.

Under the Shaar Securities Purchase Agreement, the Company agreed to (i) issue and sell 1,000,000 shares of its Common Stock (the "Shaar Shares") to Shaar, at a purchase price of \$0.50 per share, for an aggregate purchase price of \$500,000 to be paid by exchanging Shaar's rights in an aggregate amount of \$500,000 by an exchange of rights to declared and unpaid dividends on the Shares of Series A Convertible Preferred Stock currently held by Shaar; and (ii) issue a warrant to Shaar (the "Shaar Warrant") to purchase up to an aggregate of 133,333 shares of the Company's Common Stock at an exercise price of \$0.75 per share.

### ***Liquidity outlook***

At December 31, 2006, our total of cash and cash equivalents was approximately \$627,000. The total was approximately \$1,423,000 at December 31, 2005. We have financed ourselves through access to the capital markets by issuing debt securities, convertible preferred stock and common stock.

We currently require approximately \$1,700,000 per month, excluding debt related payments, to conduct our operations. During the fourth quarter of 2006, we generated approximately \$4,012,000 of revenue and expect it to increase quarterly in 2007. During the first quarter of 2007, the Company incurred approximately \$400,000 in legal and accounting fees with respect to the unsuccessful takeover

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bid for a Canadian organization (refer Note X Events occurring subsequent to December 31, 2006 for more information). The amount is expected to be paid over the first six months of 2007.

During 2006, the Company incurred significant expenses in order to complete several SB-2 registration statements related to various financing transactions. While the Company does not expect these costs to continue into 2007, there will be additional costs incurred in order for the Company to comply with Section 404 of the Sarbanes-Oxley Act of 2002.

In August 2006, the Company agreed with certain 2004 and 2005 Subordinated Investors to exchange the principal amounts outstanding under their 2004 and 2005 Subordinated Notes, plus accrued and unpaid interest thereon, and certain liquidated damages, for shares of the Company's Series C Convertible Preferred Stock. The exchange enabled the Company to reduce its debt dependence, and short-term repayment obligations significantly.

We need to obtain additional funding to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. Therefore, we need to obtain additional financing through the issuance of debt or equity securities, or to restructure our financial position through similar transactions to what was consummated during 2006. The Company's Series A Convertible Preferred Stock may be redeemable in cash by the stockholders during the second quarter of 2008, if certain stock price performance conditions are not met. This date was deferred from March 3, 2007 to March 3, 2008 by an agreement with the holders of the Series A shares on March 28, 2007.

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

### CONTRACTUAL OBLIGATIONS

We have various contractual obligations impacting our liquidity. The following represents some of our contractual obligations as of December 31, 2006:

	<u>Total</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Non-cancelable operating leases	\$ 2,198,121	\$ 1,285,970	\$ 874,605	\$ 36,089	\$ 1,457
Senior secured convertible term notes	4,797,895	3,048,421	1,749,474		
Subordinated unsecured convertible term notes	17,188	17,188			
<b>Total</b>	<b>\$ 7,013,204</b>	<b>\$ 4,351,579</b>	<b>\$ 2,624,079</b>	<b>\$ 36,089</b>	<b>\$ 1,457</b>

The Company does not own any real estate but conducts operations from four leased premises. These non-cancelable operating leases expire a various dates through 2010. In addition to base rent, the Company pays for property taxes, maintenance, insurance and other occupancy expenses according to the terms of the individual leases.

## RESTATEMENT

In the process of reviewing our registration statement for the securities issued in our June 2005 financing, the staff of the Securities and Exchange Commission ("SEC") raised questions with regard to our convertible term notes suggesting that we consider EITF 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" to evaluate whether there were any embedded derivative instruments and if so, whether they should be accounted for as an equity or liability classification. The SEC staff suggested that we review the methodology used in the valuations of the embedded derivative instruments and also review whether warrants issued with our 2004 financing should be accounted for as an equity or liability classification. The SEC staff also commented that the Company should review the convertible notes issued in fiscal 2003 and 2004. The SEC staff also asked us to review adjustments to revenue made in the fourth quarter of 2004. The SEC staff raised the question of whether the transactions had a material impact on previously filed Exchange Act reports and would be better characterized as restatements.

There were several items that were identified as requiring restatement, these items were:

### *Revenue Recognition*

The Company reviewed contracts and purchase agreements related to certain non-governmental customers and identified specific contracts for which the initial accounting inflated annual and quarterly revenues and earnings in violation of generally accepted accounting principles ("GAAP"). These practices were primarily the result of recognizing revenue on transactions with customers that were not creditworthy and recognizing revenue when the earnings process had not been completed. The revenue and related cost has been adjusted on the income statement as well as the related balance sheet accounts.

### *Accounting for Convertible Financing Arrangements*

The Company reviewed the initial accounting for the 7% Convertible Notes issued in 2003, the Senior and Subordinated Convertible Term Notes issued in 2004 and the Senior and Subordinated Convertible Term Notes issued in 2005. During the review the company identified that EITF 00-19 should be applied to evaluate whether any embedded derivative instruments qualify as equity instruments or as liabilities. As such certain embedded derivatives were identified that met the conditions set forth under paragraph 12 of SFAS No. 133. These embedded derivative instruments have been evaluated using EITF 00-19 paragraphs 12 to 32 and determined that these instruments would not be classified as components of stockholders equity. The instruments have been deemed liabilities, and as such will be subject to SFAS 133 and should be recorded at fair value. Features that have been evaluated and determined to require such treatment include:

The principal conversion option

The monthly payments conversion option

The interest rate adjustment provisions.

Additionally, it was identified that certain other components of the related financings were also incorrectly accounted for. This includes the warrants issued with the above financing and the costs incurred by Company in obtaining the above financings. The correction of prior errors affected the subsequent accounting for debt conversions to equity as well as the amortization of related discounts and deferred finance charges associated with the above financings.

### *Accounting for Warrants Related to the Companies 2004 Debt Financing*

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Based on certain registration rights provisions it was determined that the warrants issued with the 2004 Debt Financing would require continued classification as a liability and revalued every

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quarter. The Company previously classified the warrants as equity upon the registration rights agreement becoming effective during the fourth quarter of 2004.

### *Valuations of Embedded Derivatives*

The initial valuation methodology overstated the value of the conversion option derivatives. The company's review of the valuations of the embedded derivatives determined that the valuation of the principal conversion option and the monthly payments conversion option shared certain components that resulted in a double counting of the embedded derivative valuation. As such the company has adjusted its valuations of these embedded derivatives.

### *Additional Derivative (Default Provision)*

The company also reviewed the default provisions set forth in the debt instruments and determined that an additional embedded derivative existed that required bifurcation from the host contract and would need to be revalued on a quarterly basis.

The Company reviewed the earnout calculations performed in the prior year for the PSG acquisition and identified an error in the calculation. As a result the Company has restated the prior year's impact relating to this error. At December 31, 2004 the Company had accrued \$43,635 for the earnout provision. The corrected calculation resulted in no accrual being required, and as such the related accrual and goodwill balances have been reduced by \$43,635.

Management believes the scope and process of its internal review of previously reported financial information was sufficient to identify issues of a material nature that could affect our Consolidated Financial Statements and all dates and periods presented herein have been restated to fairly present the results of our operations.

The errors in our previously reported financial information, and the failure to prevent them or detect them in our financial reporting process, were largely attributable to weak internal controls, an inadequate staff of competent accounting personnel with an appropriate level of knowledge of GAAP and to errors in the valuations of the previously identified embedded derivatives.

As a result of our review and communications with the SEC, we determined that a restatement of previously reported financial information was required. Our previously reported financial information should no longer be relied upon. Accordingly, we have restated our previously reported financial information for the years ended December 31, 2003, 2004 and 2005 and our previously reported unaudited financial statements for the first, second and third quarters of 2003, 2004 and 2005 (the "restatement"). The restatement covered a number of separate matters, each of which is described above.

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The following tables summarize the impact of all of these adjustments on previously reported revenue and assets, liabilities, and stockholders' equity (deficit) for the year ended December 31, 2005.

	<b>Impact of Adjustments on Revenue For the Year Ended December 31, 2005</b>	
	<hr/>	
<b>As previously reported</b>	\$	14,226,095
Revenue recognition		
	<hr/>	
<b>As restated</b>	\$	14,226,095
	<hr/>	

	<b>Impact of Adjustments on Consolidated Balance Sheet Accounts</b>		
	<hr/>		
	<b>As of December 31, 2005</b>		
	<hr/>		
	<b>Total Assets</b>	<b>Liabilities</b>	<b>Stockholders' Equity (Deficit)</b>
	<hr/>	<hr/>	<hr/>
<b>As previously reported</b>	\$ 26,357,934	\$ 17,050,206	\$ 9,307,728
Debt financing		3,143,724	(3,143,724)
	<hr/>		
<b>As restated</b>	\$ 26,357,934	\$ 20,193,930	\$ 6,164,004
	<hr/>		

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The following table presents the effect of the restatement adjustments on the consolidated Statement of Operations for the year ended December 31, 2005.

	Year Ended December 31, 2005		
	As Previously Reported	Effect of Restatement	As Restated
<b>Revenues</b>			
Services	\$ 10,861,649	\$	\$ 10,861,649
License fees and other	3,364,446		3,364,446
	<u>14,226,095</u>		<u>14,226,095</u>
<b>Costs and other expenses</b>			
Services	2,906,142		2,906,142
Cost of license fees and other	937,491		937,491
Selling, general and administrative	11,824,609		11,824,609
Research, development and engineering	6,846,035		6,846,035
	<u>22,514,277</u>		<u>22,514,277</u>
<b>Operating loss</b>	(8,288,182)		(8,288,182)
<b>Other income (deductions)</b>			
Interest income	35,958		35,958
Interest expense	(6,548,130)	2,026,786	(4,521,344)
Derivative and warrant fair value adjustments	15,213,186	(6,058,235)	9,154,951
Loss on sale of marketable securities	(20,000)		(20,000)
Other expense	(34,767)		(34,767)
	<u>8,646,247</u>	<u>(4,031,449)</u>	<u>4,614,798</u>
<b>NET INCOME (LOSS)</b>	<u>\$ 358,065</u>	<u>\$ (4,031,449)</u>	<u>\$ (3,673,384)</u>
<b>Basic Loss per Share:</b>			
<i>Numerator</i>			
Net loss	\$ 358,065	\$ (4,031,449)	\$ (3,673,384)
Convertible preferred stock dividends and accretion	(313,517)		(313,517)
	<u>44,548</u>	<u>(4,031,449)</u>	<u>(3,986,901)</u>
Net Income (Loss) attributable to common shareholders	\$ 44,548	\$ (4,031,449)	\$ (3,986,901)
<i>Denominator</i>			
Weighted average common shares outstanding	44,787,807	44,787,807	44,787,807
<b>Basic Loss per Share</b>	<u>\$ 0.00</u>	<u>\$ (0.09)</u>	<u>\$ (0.09)</u>
<b>Diluted Loss per Share:</b>			
<i>Numerator</i>			
Net Income (loss) attributable to common shareholders	\$ 44,548	\$ (4,031,449)	\$ (3,986,901)
Effect of Dilutive Securities: Convertible Debentures	(8,795,834)	6,758,889	(2,036,945)
	<u>(8,751,286)</u>	<u>2,727,440</u>	<u>(6,023,846)</u>
Net loss attributable to common shareholders and assumed conversions	\$ (8,751,286)	\$ 2,727,440	\$ (6,023,846)

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Year Ended December 31, 2005

<i>Denominator</i>			
Weighted average shares outstanding	44,787,807		44,787,807
Effect of Dilutive Securities: Convertible Debentures	7,258,496		7,258,496
Diluted weighted average common shares and common equivalents outstanding	52,046,303	52,046,303	52,046,303
<b><i>Diluted Loss per Share</i></b>	<b>\$ (0.17)</b>	<b>\$ 0.05</b>	<b>\$ (0.12)</b>

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The following table presents the effect of the restatement adjustments on the Consolidated Statement of Cash Flows for the year ended December 31, 2005.

**CONSOLIDATED STATEMENT OF CASH FLOWS**

	Year Ended December 31, 2005		
	As Previously Reported	Effect of Restatement	As Restated
<b>CASH FLOW FROM OPERATING ACTIVITIES:</b>			
Net Loss	\$ 358,065	\$ (4,031,449)	\$ (3,673,384)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>			
Derivative and warrant fair value adjustments	(15,213,186)	6,058,235	(9,154,951)
Depreciation	244,450		244,450
Amortization:			
Intangible assets	1,323,601		1,323,601
Deferred financing costs	186,279		186,279
Discounts on convertible debt related to warrants and beneficial conversion features	4,124,759	(2,026,786)	2,097,973
Allowance for doubtful receivables	48,148		48,148
(Gain) Loss on sale of marketable debt securities	20,000		20,000
Deferred rent	(393,677)		(393,677)
Options and warrants issued for services and other	664,043		664,043
<b>Change in assets and liabilities:</b>			
Accounts receivable trade	345,050		345,050
Costs and earnings in excess of billings on uncompleted contracts	2,468,770		2,468,770
Inventories	20,839		20,839
Prepaid expenses and other	(65,227)		(65,227)
Accounts payable	(549,036)		(549,036)
Billings in excess of costs and earnings on uncompleted contracts	(317,737)		(317,737)
Accrued liabilities	1,029,404		1,029,404
Deferred revenue	1,191,958		1,191,958
Net cash used in operating activities	(4,513,497)		(4,513,497)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Capital expenditures	(148,616)		(148,616)
Proceeds from sale of marketable debt securities	980,000		980,000
Deposits	1,009,471		1,009,471
Patents and patents pending	(65,786)		(65,786)
Other	50,000		50,000
Net cash provided by (used in) investing activities	1,825,069		1,825,069
<b>CASH FLOW FROM FINANCING ACTIVITIES:</b>			
Net advance from (to) stockholders	(12,753)		(12,753)
Issuance of convertible bridge notes	250,000		250,000
Repayment of convertible bridge notes	(250,000)		(250,000)
Issuance of long-term obligations	4,822,250		4,822,250
Repayment of long term obligations	(1,908,212)		(1,908,212)
Financing costs	(248,406)		(248,406)
Exercise of warrants	558,788		558,788
Payment of offering costs	(56,642)		(56,642)
Net cash provided by financing activities	3,155,025		3,155,025

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Year Ended December 31, 2005

<b>NET INCREASE (DECREASE) IN CASH</b>	466,597	466,597
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	956,230	956,230
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<b>\$ 1,422,827</b>	<b>\$ 1,422,827</b>

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## CRITICAL ACCOUNTING POLICIES

### 1. *Basis of Consolidation*

The accompanying consolidated financial statements include the accounts of BIO-key International, Inc. and its wholly owned subsidiary (collectively, the Company) and are stated in conformity with accounting principles generally accepted in the United States, pursuant to the rules and regulations of the Securities and Exchange Commission. Intercompany accounts and transactions have been eliminated in consolidation.

### 2. *Revenue Recognition*

Revenues from software licensing are 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 collectability is probable.

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

**Multiple-Element Arrangements:** For multiple-element arrangements, 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). 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.

Revenue from licensing software, which requires significant customization and modification, is recognized using the percentage of completion method, based on the hours of effort incurred by the company in relation to the total estimated hours to complete. In instances where third party hardware, software or services form a significant portion of a customer's contract, the company recognizes revenue for the element of software customization by the percentage of completion method described above. Third party hardware, software, and services are recognized upon shipment or acceptance as appropriate. If the company makes different judgments or utilizes different estimates of the total amount of work expected to be required to customize or modify the software, the timing and revenue recognition, from period to period, and the margins on the project in the reporting period, may differ materially from amounts reported. Revenues earned but not yet billed are shown as an asset in Costs and Earnings in Excess of Billings in the balance sheet. Billings in excess of cost and earnings are reflected as a liability in the balance sheet. Anticipated contract losses are recognized as soon as they become known and are estimable.

**Service Revenues:** Revenues from services are comprised of maintenance and consulting and implementation services. Maintenance revenues include providing for unspecified when-and-if available product updates and customer telephone support services, and are recognized ratably over the term of

the service period. Consulting services are generally sold on a time-and-materials basis and include a range of services including installation of software and assisting in the design of interfaces to allow the software to operate in customized environments. Services are generally separable from other elements under the arrangement since performance of the services are not essential to the functionality of any other element of the transaction and are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services. Revenues from services are generally recognized as the services are performed.

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

### 3. *Accounting for Acquisitions*

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

### 4. *Marketable Debt Securities*

The Company accounts for marketable securities pursuant to Statement of Financial Accounting Standards No. 115 "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"). SFAS 115 requires classification of debt and equity securities in three categories: trading securities, available-for-sale securities and held-to-maturity securities. Debt and equity securities classified as trading securities are carried at fair value with unrealized gains or losses included in income. Debt and equity securities designated as available-for-sale, whose fair values are readily determinable, are carried at fair value with unrealized gains or losses included as a component of accumulated other comprehensive income, net of applicable taxes. Debt securities that are expected to be held-to-maturity are carried at amortized cost. In January 2005 the Company sold these investments and did not hold any Marketable Debt Securities as of December 31, 2006.

### 5. *Derivative and Warrant financial instruments*

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

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

volatility of our common stock price over the life of the option. The identification of, and accounting for, derivative instruments and the assumptions used to value them can significantly affect our financial statements.

6. *Goodwill and Intangible Assets*

Goodwill represents the excess of costs of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The Company has adopted Statement of Financial Accounting Standards No. 142 ("SFAS 142"), Goodwill and Other Intangible Assets., which requires the Company to test goodwill for impairment annually or whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable, rather than amortize. Accordingly, the Company has not amortized goodwill. As provided by SFAS No. 142, the Company has elected to perform the annual assessment of the carrying value of all goodwill as of September 30<sup>th</sup> of each year using a number of criteria, including the value of the overall enterprise. As of December 31, 2006, the Company believes that no material impairment exists. Future impairment charges from previous or future acquisitions, if any, will be reflected as an operating expense in the statement of operations.

7. *Deferred Revenue*

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

8. *Research and Development Expenditures*

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

9. *Earnings Per Share of Common Stock*

Earnings per share of common stock-basic is computed by dividing Net Income applicable to common stockholders by the weighted-average number of common shares outstanding for the period. Earnings per share of common stock-assuming dilution reflects the maximum potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock and would then share in the net income of the company. See Note V Earnings Per Share "EPS," for additional information.

10. *Income Taxes*

The provision for, or benefit from, income taxes includes deferred taxes resulting from the temporary differences in income for financial and tax purposes using the liability method. Such temporary differences result primarily from the differences in the carrying value of assets and liabilities. Future realization of deferred income tax assets requires sufficient taxable income within the carryback, carryforward period available under tax law. The Company evaluates, on a quarterly basis whether, based on all available evidence, if it is probable that the deferred income tax assets are realizable. Valuation allowances are established when it is more likely than not that the tax benefit of the deferred tax asset will not be realized. The evaluation, as prescribed by Statement of Financial Accounting

Standards No. 109, "Accounting for Income Taxes," includes the consideration of all available evidence, both positive and negative, regarding historical operating results including recent years with reported losses, the estimated timing of future reversals of existing taxable temporary differences, estimated future taxable income exclusive of reversing temporary differences and carryforwards, and potential tax planning strategies which may be employed to prevent an operating loss or tax credit carryforward from expiring unused. Because of the Companies historical performance and estimated future taxable income a full valuation allowance has been established.

11. *Accounting for Stock-Based Compensation*

As of January 1, 2006, the Company adopted SFAS 123R using the modified prospective method, which requires measurement of compensation cost for all stock awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. Accordingly, financial statement amounts for the prior periods presented in this Form 10-KSB have not been restated to reflect the fair value method of expensing share-based compensation. Under this application, we are required to record compensation cost for all share-based payments granted after the date of adoption based on the grant date fair value estimated in accordance with the provisions of SFAS 123R and for the unvested portion of all share-based payments previously granted that remain outstanding which were based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. The majority of our share-based compensation arrangements vest over either a three or four year vesting schedule. The Company expenses its share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS 123, as amended by SFAS 148, and requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (the "expected option term"), the estimated volatility of our common stock price over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield. Changes in these subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized as an expense in the consolidated statements of operations. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, are likely to change our valuation assumptions used to value employee stock-based awards granted in future periods. The values derived from using the Black-Scholes model are recognized as expense over the requisite service period, net of estimated forfeitures (the number of individuals that will ultimately not complete their vesting requirements). The estimation of stock awards that will ultimately vest requires significant judgment. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

12. *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 revenues and expenses during the reporting period, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Estimates and assumptions which, in the opinion of management are used in accounting for, among other things, long-term contracts, allowances for uncollectible receivables, recoverability of goodwill and other long-lived assets, depreciation and amortization, valuation of deferred income taxes,

convertible notes and related discounts, embedded derivatives, preferred stock, stock options, and warrants outstanding.

#### **RECENT ACCOUNTING STANDARDS**

In February, 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," which is effective for calendar year companies on January 1, 2008. The statement allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 further establishes certain additional disclosure requirements. Management is currently evaluating the impact and timing of the adoption of SFAS 159 on the Corporation's financial condition and results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which is effective for calendar year companies on January 1, 2008. The Statement defines fair value, establishes a framework for measuring fair value in accordance with Generally Accepted Accounting Principles, and expands disclosures about fair value measurements. The Statement codifies the definition of fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The Company is currently assessing the potential impacts of implementing this standard.

In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) Topic 1N (SAB 108), "Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," which is effective for calendar year companies as of December 31, 2006. SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the financial statements are materially misstated. Under this guidance, companies should take into account both the effect of a misstatement on the current year balance sheet as well as the impact upon the current year income statement in assessing the materiality of a current year misstatement. Once a current year misstatement has been quantified, the guidance in SAB Topic 1M, "Financial Statements Materiality," (SAB 99) should be applied to determine whether the misstatement is material. The implementation of SAB 108 did not have a material impact on the Company's financial statements.

In June 2006, the FASB issued FIN No. 48, "Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109," which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective for the Company's first interim period beginning January 1 2007. The implementation of FIN 48 is not expected to have a material impact on the Company's financial statements.

## DESCRIPTION OF BUSINESS

### Overview

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

On March 30, 2004, BIO-key acquired Public Safety Group, Inc. (PSG), a privately held company that is a leader in wireless solutions for law enforcement and public safety markets. PSG's primary technology is PocketCop, a handheld solution that provides mobile officers, such as detectives who are not typically in their vehicles, a hand-held mobile information software solution.

On September 30, 2004, BIO-key completed a transaction with Aether Systems, Inc. to purchase its Mobile Government Division ("Mobile Government" or "AMG"), a leading provider of wireless data solutions for use by public safety organizations, primarily state, local police, fire and rescue and emergency medical services organizations. The PacketCluster mobile information software is integrated with 50 separate State/NCIC databases, as well as other state, local and federal databases. Its open architecture and its published Application Programming Interface (API) make it easy to interface with a wide range of information sources. PacketCluster products deliver real-time information in seconds, freeing dispatchers to handle more pressing emergencies.

Effective January 1, 2005, BIO-key International, Inc., a Minnesota corporation ("Old BIO-key"), reincorporated in the State of Delaware. The reincorporation was effected pursuant to an Agreement and Plan of Merger (the "Merger Agreement") whereby Old BIO-key was merged with and into the Company, its wholly owned subsidiary, in order to reincorporate in the State of Delaware (the "Reincorporation"). As a result of the Reincorporation, the legal domicile of the Company is now Delaware.

Pursuant to the Merger Agreement, at the effective time of the Reincorporation: (i) each outstanding share of Common Stock of Old BIO-key, \$0.01 par value per share, was automatically converted into one share of Common Stock, \$0.0001 par value per share, of the Company; (ii) each outstanding share of Series C 7% Convertible Preferred Stock of Old BIO-key, \$0.01 par value per share, was automatically converted into one share of Series A 7% Convertible Preferred Stock, \$0.0001 par value per share, of the Company, with such Series A 7% Convertible Preferred Stock containing substantially identical terms and conditions as the Series C 7% Convertible Preferred Stock of Old BIO-key; (iii) each option to purchase shares of Old BIO-key's Common Stock granted by Old BIO-key under any warrant, stock option plan or similar plan of Old BIO-key outstanding immediately before the Reincorporation was, by virtue of the Merger Agreement and without any action on the part of the holder thereof, converted into and become an option to purchase, upon the same terms and conditions, the same number of shares of the Company's Common Stock at an exercise price per share equal to the exercise price per share thereunder immediately before the Reincorporation; and (iv) each warrant, option or stock option plan of Old BIO-key was assumed by, and continues to be, a warrant, option or plan of the Company. Accordingly, as a result of the Reincorporation, the shareholders of Old BIO-key became shareholders of the Company, and Old BIO-key has been merged out of existence by operation of law. Each certificate representing shares of capital stock of Old BIO-key outstanding immediately before the Reincorporation, is deemed from and after the Reincorporation for all corporate purposes to represent the same number of shares of capital stock of the Company.

As a result of these mergers, and as discussed in Note M to the Consolidated Financial Statements included in this report, we have organized the Company into three reporting segments: Law



Enforcement, Fire Safety and Biometrics. During 2006, the Company continued to integrate the products, operations and technologies acquired from Public Safety Group, Inc. and Aether Systems, Inc.

## **Markets**

### ***Finger-based Biometric Identification***

BIO-key is a leader in finger-based biometric identification. In partnerships with OEMs, integrators, and solution providers, we provide biometric software solutions to private and public sector customers. BIO-key's patented vector segment technology is the foundation for these solutions. BIO-key's WEB-key® is a cost-effective, easy-to-deploy, fingerprint-based, strong authentication system. This unique solution allows users to positively identify themselves to any application with the simple scan of their finger. This capability is a significant improvement in both convenience and security over other alternatives and provides companies with a cost-effective solution to thwart phishing attacks and comply with government regulations and legislation such as FFIEC compliance, HIPAA, HSPD-12, and the Electronic Signatures Act. BIO-key couples these capabilities with device interoperability and system flexibility and scalability. BIO-key enables the use of 40 different fingerprint sensor technologies to enroll and identify employees, customers or business partners. Most recently, BIO-key integrated its biometric capabilities with its public safety mission with the introduction of ID-Engine , a real-time, in-station solution that allows law enforcement professionals to manage the identity of a suspect simply by using their fingerprint. BIO-key has also formed relationships with providers of biometric logon software like IdentiPHI, Softex, and Computer Associates to provide enterprise-ready SingleSignOn systems to many large companies in the US and abroad. Also, BIO-key has integrated VST to a pure physical access solution in NextGenID, which has been deployed across the US at many leading companies.

*Growth potential* As the provider of the core technology, BIO-key's greatest growth potential for this market is as a partner with companies that offer applications that address growing concerns particularly about identity theft and anti-terrorism.

For example, BIO-key has implemented programs that will enable biometric logical and physical access. These include IdentiPHI to provide strong network based authentication on BIO-key technology; and with the Pegasus Program to authenticate users accessing a nationwide information-sharing system designed by and for the nation's sheriffs. These represent the kind of partnership-based opportunities BIO-key may see in the finger-based biometric market.

In parallel, BIO-key is both strengthening security and improving user and system administrator convenience by integrating biometric log-in, as well as two-factor authentication, with its law enforcement and fire safety products. This is a true differentiator to potential new customers, and creates add-on opportunities with existing customers. Fingerprint identification of First Responders has been identified as a way to facilitate disaster recoveries, and these integrated projects have been receiving funding from the Department of Homeland Security. By promoting our integration of fingerprints for this use, we can capitalize on our vast customer base and drive new revenue.

### ***Law Enforcement***

BIO-key's InfoServer, MobileCop and PocketCop law enforcement products are a leading wireless mobile data communications client/server solution, implemented in more than 700 agencies in 43 states. Providing immediate access to mission-critical data and enabling in-field reporting, BIO-key software keeps officers on the street, improving their productivity and enhancing officer safety. BIO-key solutions are able to run across any and all wireless infrastructures and integrate with virtually all computer-aided dispatch (CAD) and records management systems. This makes us a leader in multi-

agency cooperation and interoperability, which are absolutely critical in times of large-scale natural and terrorist threats.

*Growth potential* BIO-key's large base of more than 700 law enforcement agencies continues to be a strength that helps leverage additional sales from both existing customers and new customers. The 2005 Gartner study entitled "Forecast: State and Local Government, North America 2005-2008" projects that the Law Enforcement Mobile Data market (hardware and software) will grow at 15% AAGR to \$299 million in 2008.

A key opportunity is the growing awareness of the need for multi-agency interoperability. In these situations, BIO-key offers:

BIO-key's LE products, which can run on any and all wireless infrastructures. BIO-key also has had success implementing seamless roaming across multiple infrastructures for multi-agency consortiums.

BIO-key's open architecture.

BIO-key's experience in large, complex and multi-agency implementations, such as Hamilton County, Ohio Sheriff's Office and Pennsylvania State Police.

These capabilities position BIO-key well to work with leading CAD vendors, even with vendors that have mobile data solutions but do not have the depth of interoperability capability that BIO-key offers.

An additional growth area is the introduction of BIO-key's finger-based biometric identification to law enforcement. In addition to now offering biometric login to our traditional InfoServer product, we have introduced the ID-Engine fingerprint identification solution, which lets law enforcement personnel capture fingerprints in the field. Using BIO-key's patented Vector Segment Technology, ID-Engine analyzes and categorizes fingerprints the same way a fingerprint expert would only faster. ID-Engine also enables multiple law enforcement agencies to share fingerprint data with other agencies. This powerful tool, built on BIO-key's understanding of law enforcement requirements and its fingerprint technology, presents opportunities for the law enforcement business segment in the coming year. The 2005 Gartner study entitled "Forecast: State and Local Government, North America 2005-2008" projects that the Law Enforcement Biometrics market will grow at 15% AAGR to \$190 million in 2008.

### ***Fire Service***

According to the United States Fire Administration the number of fire calls has decreased over the past year while the number of medical calls has increased. Medical aid calls have nearly tripled since 1980 and there were 984,000 Mutual Aid calls in 2004.

In a 2002 study entitled, "A Needs Assessment of the U.S Fire Service," conducted by the Federal Emergency Management Agency ("FEMA") and the National Fire Protection Association ("NFPA"), it was reported that only three-fifths to four-fifths of fire departments (64% to 77%, by size of community protected) report they are able to communicate at incident scenes with their Federal, state, and local partners. Of these, though, only one-third report they are able to communicate with all their partners. This means only about one-fourth of departments overall can communicate with all partners, which results in a serious communication gap in the event of a large scale incident.

*Growth potential* BIO-key's suite of fire/EMS products are positioned to follow the trends of the fire/EMS service. FireRMS meets HIPAA requirements and with the recent certification of compliance to NEMESIS, fire departments performing EMS functions can manage and report incidents securely and easily while meeting national standards.

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With FireRMS Mobile allowing EMS workers to collect critical patient data and relay the data to medical personnel. FireRMS Mobile also supports the 34% of fire departments performing inspections. This new mobile approach to fire and EMS data collection and access offers great potential among both new and existing FireRMS customers.

In addition BIO-key's Fire/EMS products were designed to easily interface with most third-party applications to facilitate the exchange of information. FireRMS, FireRMS Mobile and MobileRescue complemented with strategic partner solutions improve interoperability at an incident.

### Products

BIO-key® operates in three major segments biometrics, law enforcement and fire/EMS Services. These segments are described below and a list of products in each line is noted.

#### *Biometrics*

The Company's biometric identification technology improves both the accuracy and speed of finger-based biometrics. The Company's proprietary biometric technology extracts unique data from a fingerprint and uses it to positively identify an individual. The technology has been built to be completely scalable to handle databases containing millions of fingerprints. BIO-key achieves the highest levels of discrimination without requiring any other identifying data like a userID, smart card, or token. BIO-key's core technology supports interoperability on over 40 different commercially available readers. This interoperability is a key differentiator for BIO-key in the biometric market. BIO-key has full support for industry standards and recently received NIST certification on its ability to support HSPD-12 supported INCITTS-378 templates. Extending our products to support standards enables BIO-key to participate in large government projects like Transportation Workers Identification Card(TWIC), Registered Traveler projects, PIV initiatives, and FIXS consortium solutions. We believe our fingerprint identification technology has a broad range of information security and access control applications, including:

Securing Internet sites and electronic transactions

Securing access to logical networks and applications

Securing access to buildings and restricted areas

Providing fast, accurate member identification services

Securing mobile devices such as biometric enabled handhelds and PDA's

Preventing identity theft through positive user identification and false alias validation

#### **Biometric Products:**

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

**Vector Segment Technology SDK (VST)** BIO-key's biometric development kit that provides developers the ability to take advantage of a highly accurate, device interoperable algorithm. VST is available as a low level SDK for incorporation into any application architecture to increase security while not sacrificing convenience. VST runs on Windows, Linux or Solaris systems.

**True User Identification®** BIO-key's biometric identification solution that offers large scale one to many user lookup with nothing but a single fingerprint. This solution enables customers to perform false alias checks and manage fraudulent access to systems. True User Identification



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leverages commercially available databases, like Oracle, to scale the identification capabilities to millions of users. The solution also runs on commercially available hardware making it truly scalable for any size system.

**WEB-key®** BIO-key's biometric security platform for managing fingerprint authentication across unprotected networks like the internet. It extends all features and functionalities of the VST algorithm to customers looking to add an enhanced level of security to their thin client and client/server applications. WEB-key currently is supported by both Windows and Linux operating systems.

**Biometric Service Provider** BIO-key provides support for the BioAPI (a standards based solution meeting worldwide needs) for a compliant interface to applications using biometrics for verification and identification. BIO-key enhances the traditional use of the BioAPI by adding support for CE devices, supporting identification calls and also providing a single user interface for multiple fingerprint readers.

**ID Director** BIO-key's solution for single sign on integration with Computer Associates SiteMinder, Oracle's Fusion Middleware SSO, and other solutions, utilizing the power and security of WEB-key. This solution provides a simple to implement, custom authentication scheme for companies looking to enhance authentication. ID Director can easily add a level of security and convenience to the transaction level of any application.

### *Law Enforcement*

**MobileCop®** A complete wireless query and messaging application that puts the power of mobile and wireless technology to work for agencies of every size, MobileCop® sets the standard for mobile law enforcement. Providing real-time retrieval of motor vehicle, warrant and criminal history information, powerful mobile integration capabilities, and an intuitive user interface, MobileCop delivers the most in performance and it's easy to see why over 700 law enforcement agencies around the country have deployed MobileCop for fast and secure access to critical information in the field.

**PocketCop®** PocketCop is a software solution that provides law enforcement personnel with instantaneous access to criminal, civil, and local database information in a wireless environment. PocketCop is a handheld application that provides access to state and federal databases over the wireless network for Windows Mobile, and RIM OS devices. Using a portable wireless handheld device and the PocketCop application software, an authorized user can access suspect information such as wanted status, warrant status, vehicle registration and driver license status. PocketCop technology has been deployed in numerous police agencies in the United States, including the Massachusetts State Police.

**ID-Engine** a web-based fingerprint biometric solution that allows various criminal custody agencies to quickly identify criminals at all points along the chain-of-custody throughout the criminal justice process. This solution enables the sharing of information between trusted entities and personnel, from the booking agencies to parolee oversight. ID-Engine allows law enforcement agencies to capture and store fingerprints locally and to identify subjects by matching their fingerprint against those stored in the database, securely and in real time. Fingerprints can be captured using a live scan device from existing 10-print cards or through a wide variety of inexpensive commercially available fingerprint readers. This is an AFIS companion, rather than a replacement product, designed to maximize the value of fingerprint data and also to provide a new level of safety for the law enforcement personnel.

**ID-Match** is the web based client front-end application for the ID-Engine system solution. It is a browser based application that retrieves detailed fingerprint records such as LiveScan, Rolled

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10-print and Latent fingerprint information and displays criminal aliases by fingerprint match along with detailed information of the actual fingerprint images.

**ID-Mobile** provides for wireless in the field identification of suspects. This application can be used in mobile laptop computers or a convenient handheld device. The features and functionality of this application are ideal for law enforcement patrol, transport vehicles, motorcycle and bike patrols, mounted and foot patrols, as well as water patrols; wherever a versatile handheld biometric reader would be essential for true suspect identification.

**ID-Track** ensures the true identification, tracking and management of criminals once they enter the criminal handling continuum. From pre-booking to parolee management ID-Track provides true suspect identification. In addition to validating true criminal identity it archives data for a historical review of enrollments and inmate activity for report query (under development).

**ID-Visit** verifies the identity of visitors registered for visitation rights to incarcerated criminals. ID-Visit can greatly reduce registration time for subsequent visits and ensures compliance with a facility's visitor policy. A history of visitor activity is maintained for historical review and report query. This application is also helpful to identify the access of pre-approved personnel such as volunteers, Chaplains, teachers, etc. (under development).

BIO-key also provides a number of optional features designed to augment the core Law Enforcement products. These include:

**Field Interview Tracker** enables personnel to capture field contact information. The data is stored in a searchable database where it can be located quickly. Police agencies can create online contact forms that meet their specific needs and multiple agencies can share information while using their own forms and procedures.

**Patrol Journal** an automated system to electronically capture and record users' daily activities, such as patrol area assignments. With Patrol Journal, statistical and summary management reports provide an accurate picture of time spent by field personnel.

**TStop** was developed to enable law enforcement agencies to comply with state mandated and voluntary traffic stop reporting. Law enforcement personnel can capture the required information on their mobile computer and transmit it to the server where it is stored for future report generation.

**State Crash Report** enables personnel to use their mobile computer to collect data needed for their state's crash report. This data can be wirelessly transmitted to a server for supervisor review and approval. Once complete the report can be printed in the state's format. Selected states are supported.

**InfoServer** BIO-key's solution for an agency's central messaging switch for application software service, State/NCIC interfaces, Computer Aided Dispatch (CAD) and Records Management Software (RMS) interfaces, data sharing and other applications.

**Multiple Application Programming Interface (API)** allows an agency to have multiple ports to the server to accommodate disparate interfaces. These multiple API ports are in addition to the one port that is inherent in the server as well as the State/NCIC interface.

### Partner applications include:

**Incident Command** using FieldSoft's AimonScene, this solution is used by both patrol and tactical teams, such as a SWAT, to manage people and resources at the scene of an incident or at a central location such as an emergency operations center. It can also be used for general event management.



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*iPass EMP software* enables wireless, remote software updates to dramatically reduce administrative time and expense, and eliminate version lags.

### **Fire/EMS Services**

*BIO-key offers a suite of products designed for Fire/EMS departments of all sizes to efficiently and securely manage daily operations and critical information. BIO-key's Fire/EMS Solutions include:*

**FireRMS** a NFIRS 5.0 and NEMSIS 2.2.1 compliant fire/EMS records management system designed to streamline reporting, and dramatically reduce report completion time for front-line personnel. This enterprise-class solution empowers departments to better manage operations, track incidents and effectively support fire prevention initiatives.

**FireRMS Mobile** an extension to the robust FireRMS application used in the department allowing access to all the FireRMS modules while you are in the field. FireRMS Mobile uses replication and synchronization technology allowing you to use FireRMS Mobile on-site without the need for a server connection. This mobile application offers real-time updates to critical information and eliminates duplication of data entry.

**MobileRescue** A wireless query and messaging solution that extends Computer Aided Dispatch (CAD), FireRMS and other in-house data sources to a mobile environment, providing mission-critical information to

emergency response personnel. MobileRescue is available with full incident command to help manage personnel, resources and incident logistics management systems.

**The Collector** A regional data collection solution that provides an easy yet very powerful way to assemble data from a region or state. The Collector imports data from Bio-key's FireRMS program and other NFIRS 5.0 compliant software. Data can then be viewed or analyzed allowing users to compare years, months or geographical areas for similar or dissimilar fire issues.

**CAD Interfaces** CAD interfaces provide a connection between BIO-key records and all major CAD systems with the most comprehensive real time integration. Incident reports are opened as soon as CAD dispatches a call. Incidents are current and ready to complete when the crew returns to the station, streamlining and improving the accuracy of incident reporting.

**EMS Interfaces** EMS interfaces provide a mechanism to integrate patient care reports collected in the field. Patient data is populated in the appropriate fields, eliminating redundant data entry.

**Other Interfaces** BIO-key provides interfaces to other third party solutions including EMS billing, EMS county/state interfaces, professional staffing solutions and others.

BIO-key also offers the following Fire/EMS Partner solutions:

**EMS Field Data Collection** Regist<sup>®</sup>r Express from MedDataSolutions enables EMS field data collection for efficient collection of patient data where it is generated.

**Geographic Data Analysis** FireView from the Omega Group allows Fire and EMS agencies to analyze their deployment strategies. FireView integrates FireRMS with GIS allowing agencies to easily map and analyze data. By identifying incident patterns and response effectiveness, resources can be more optimally redeployed.

**Personnel Staffing** Telestaff from PDSI automates and manages complex Fire/EMS agency staffing needs and is integrated with the FireRMS Personnel and Roster modules.





**Incident Command** AIMSonScene by FieldSoft provides incident management, responder accountability, and tactical survey or preplan browser software solutions. AIMSonScene interfaces with Mobile Rescue to support incident management whilst en-route or on-scene.

**Hazard Diagnostics** Threatscreen by Real Interface is triggered by the field PCR (patient care report) is an exposure-diagnostic/identification, data collection, and reporting tool used by First Responders to quickly assess victims to determine chemical, biological, or nuclear agent exposure and provides immediate access to response protocols.

## Current Business Plan

BIO-key's current business plan is to:

**License its core technology "VST" and True User Identification®** to original equipment manufacturers, systems integrators, and application developers who develop products and applications that utilize its biometric finger matching solutions.

**License WEB-key®**, the Company's security centric web-based biometric authentication solution.

**License its wireless software solutions for the public safety market** directly to counties, cities and towns across North America as well as through systems integrators and resellers.

**Leverage its FireRMS suite of products** for the growing Emergency Medical Service data collection and reporting market.

**Integrate its core technology competencies** to leverage new business opportunities and develop new markets for its innovative products.

## Competition

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

### *Biometrics*

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

The most recent automated fingerprint identification product sales in the market have been deployed for government and law enforcement applications, typically at more cost than BIO-key's products and licensing arrangements. Although most companies that target consumer application markets have completed development of their biometric products, such technologies have not been widely accepted in the commercial markets to date. Most companies competing for commercial opportunities are in the business of selling scanning devices and tie their algorithm to a specific device. BIO-key has created a "device independent" algorithm that provides flexibility in choosing the correct device and optical or tactile sense to fit the application served.

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

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

*Fingerprint identification* is generally viewed as inexpensive and non-intrusive.

*Iris scanning* is viewed as accurate, but can be expensive and inconvenient to use.

*Facial recognition* has recently received substantial attention; however, it can have accuracy limitations and be highly dependent on ambient lighting conditions, angle of view and other factors.

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

### *Law Enforcement*

The public safety market comprises agencies at all government levels, with a range of users, from a few to many hundreds. BIO-key competitors in the mobile data market include Computer Aided Dispatch/Records Management companies such as New World, Tiburon and Motorola. Each has comprehensive CAD and/or RMS offerings and has augmented those with their own mobile data and field reporting solutions. While these mobile data solutions may not be as functionally rich as the BIO-key suite of products, they are sometimes less expensive when bundled with the CAD/RMS offerings. They also provide a complete solution from one vendor.

### *Fire Services*

The fire records management market includes a large number of RMS vendors including Firehouse, FDM, 24x7 and ETI. These and other competing companies represent a wide range of organizations, from large integration companies, to small garage companies, and offer products similar in scope to BIO-key's FireRMS . The functionality and price of these products also encompass wide ranges of features and costs.

## **Marketing and Distribution**

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

During the past year, BIO-key has strengthened its alliance with Oracle and has been recognized as a Certified Partner in the Oracle Partner Network. BIO-key supports the Oracle e-business suite of applications and provides the biometric enabler for the Oracle Single Sign on product. As an Oracle development partner, BIO-key provides the underlying database used for true user identification and on demand alias checking. As a development partner, BIO-key participates in Oracle Trade Shows such as Oracle Open World and Oracle Apps World.

BIO-key's FireRMS received certification of compliance from NEMSIS which will strengthen the product's reputation with EMS agencies. Most EMS agencies will be required to use NEMSIS compliant software.

BIO-key has strategic alliances with technology leaders including Oracle, Netegrity, Hewlett Packard, Dell, Verizon, Sprint/Nextel, AT&T Wireless, and others.

BIO-key is also promoting biometric technology and its offerings through industry trade shows, public speaking engagements, press activities and partner marketing programs.

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BIO-key is directing licensing efforts to original equipment manufacturers, application developers and system integrators.

BIO-key is building a reseller, integrator and partner network as well as a direct sales team.

### **Addressing the Market**

Following are the specific marketing/sales programs in place:

*Direct Selling Efforts* BIO-key now has a base of area sales directors who are responsible for both the law enforcement and fire service markets. This team of sales professionals brings extensive experience in technical solution and relationship-based selling. They are supported by a pre-sales team that includes system engineering and proposal management and post-sales program management, implementation and training professionals. Included in this team are individuals who are themselves former police officers and firefighters.

BIO-key's direct sales force also includes area sales directors for the OEM and Federal Government markets, each of whom brings not only extensive sales experience but also expertise in emerging biometric technologies. The BIO-key sales force is rounded out by Inside Sales, which is responsible for maintaining and supporting our existing install base, acting as a front-line support for any inquiries on our product line, and facilitating activities that make the field team more productive.

*Conferences and Trade Shows* BIO-key attends and actively participates in various product-related conferences and trade shows in the technology and security industries to generate market awareness of biometric and wireless mobile data technology generally and our offerings specifically. BIO-key's public safety software often is featured at our business partners' booths at these events, showcasing the interoperability of the two products.

*Strategic Alliance* BIO-key's strategic alliances and reseller agreements with other vendors play a significant role in our overall sales efforts. In the past year, BIO-key has initiated and bolstered numerous important and promising long-term relationships. Just a few examples include:

BIO-key is partnering with AT&T Wireless, the largest wireless carrier in the country, to first responders in a seven-county Tennessee consortium of fire, police and EMS agencies in access to mission critical information using BIO-key's MobileCOP solution in conjunction with AT&T Wireless's nationwide\* EDGE wireless data network.

The Omega Group continues to provide FireView software mapping tools that help review existing deployment policies and develop new strategies, to complement BIO-key's range of solutions for Fire/EMS agencies.

BIO-key now resells solutions from ThreatScreen that provide an exposure-diagnostic/identification, data collection, and reporting tool to first responders so they can quickly assess victims to determine chemical, biological, or nuclear agent exposure.

Silex Technology America, Inc., which develops fingerprint reader products designed to support a variety of secure computing options, utilizes BIO-key's VST and WEB-key technology.

*Strategic Marketing Alliance* BIO-key has established a strategic marketing alliance with Hewlett Packard to provide BIO-key handheld technology for the Massachusetts State Police.

*Reseller Relationships* BIO-key has established reseller relationships with companies that resell BIO-key public safety software.



## Licensing

BIO-key targets both Internet infrastructure companies and large portal providers as possible licensees for its WEB-key® solution. On the Internet infrastructure side, BIO-key seeks to partner with Internet server manufacturers, providers of database and data warehouse engine software, horizontally positioned application engines, firewall solution providers and peripheral equipment manufacturers. On the portal side, BIO-key is targeting financial service providers such as credit and debit card authorization and issuing institutions, Internet retailers, business-to-business application service providers (ASPs) and corporate intranets. In the past three years, BIO-key has undertaken a WEB-key® and VST direct selling effort, and entered into license agreements with OEMs and system integrators to develop applications for distribution to their respective customers.

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

*Government* Using BIO-key's technology, Northrup Grumman deployed an application within the Department of Defense to cross-credential visitors and contractors to certain military bases.

*Education* Educational Biometric Technologies, Lunch Byte Systems and Identimetrics have incorporated BIO-key technology to enable school children to pay for school lunch programs and checkout library books using their fingerprints. VST technology enables schools to enroll these children and reduces the administrative costs of managing passwords and collecting payments.

*Commerce* ChoicePoint has implemented a check cashing solution using BIO-key's VST technology to reduce fraud and identity theft.

*Patient Records and Information Management* HBOC, one of the largest healthcare patient records and information management companies, has integrated BIO-key technology into their portal and has deployed their solution in a pilot for the Baptist Hospital System.

*Financial* BIO-key is working with several companies focusing on financial applications such as point of sale systems and employee trusted identification cards, as well as customer facing applications over the Internet. BIO-key has also begun work with several financial institutions to incorporate its technology for secure access to money transfers for institutional customers.

## Intellectual Property Rights

We believe that our intellectual property is important to our biometric, law enforcement and fire information management segments:

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

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

On August 29 2006, BIO-key announced that the Company's patent for biometric identification indexing, a core feature of its VST software, has been granted in Europe. In addition, a WEB-key® authentication security patent for "Systems and Methods of Secure Biometric Authentication" has been issued in South Africa. These patents enhance the worldwide protection of BIO-key's technology. The European patent for VST, which provides BIO-key with protection of its intellectual property in Europe, was issued on March 29, 2006 and covers a similar set of claims for a patent BIO-key was granted in 2005 in the United States. BIO-key expects the patent for Secure Biometric Authentication, issued in South Africa on April 26, 2006, to be issued in the United States in the near future

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

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

Additionally, we have a number of U.S. and foreign patent applications in process related to this intellectual property.

*Trademarks* We have registered our trademarks ("BIO-key", "True User Identification", "WEB-key", "PacketCluster", "PacketCluster Patrol", "PacketWriter", "PocketCop", "VirtualCop", "MobileCop", and the design

mark for "Ceurulean", with the U.S. Patent & Trademark Office. We have also applied for trademarks for "Cerulean".

*Copyrights and trade secrets* We take measures to ensure copyright and license protection for our software releases prior to distribution. When possible, the software is licensed in an attempt to ensure that only licensed and activated software functions to its full potential. We also take measures to protect the confidentiality of our trade secrets.

## Research and Development

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

On November 27, 2006, BIO-key announced that it has been awarded the Gold Level Compliance Certification for its FireRMS software application by the National Emergency Medical Services Information System (NEMSIS). The certification process was developed to help states collect more standardized elements and eventually submit the data to a national EMS database. Gold Level Compliance ensures that BIO-key FireRMS software conforms to the NEMSIS national EMS dataset.

The NHTSA Version 2.2.1 data elements required for compliance include over 400 data elements which are vital components needed for the documentation and description of EMS systems and patient care.

During the fiscal years ended December 31, 2006 and 2005, BIO-key spent approximately \$6,514,000 and \$6,846,000 respectively, on research, development and engineering. BIO-key's limited customer base during that time did not directly bear these costs, which were principally funded through outside sources of equity and debt financing.

#### **Government Regulations**

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

#### **Environmental Regulations**

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

#### **Employees and Consultants**

BIO-key currently employs one-hundred (100) individuals on a full-time basis: fifty-one (51) in engineering, customer support, research and development; Thirteen (13) in finance and administration; and twenty-six (26) in sales and marketing. BIO-key also uses the services of ten (10) consultants who provide engineering and technical services.

### **DESCRIPTION OF PROPERTY**

We do not own any real estate. We conduct operations from leased premises in Marlborough, Massachusetts (38,000 square feet), Eagan, Minnesota (6,800 square feet), Wall, New Jersey (2,180 square feet) and Fulton County, Georgia, (360 square feet). We believe that our current facilities are adequate for the foreseeable future.

### **LEGAL PROCEEDINGS**

Prior to our acquisition of PSG in March 2004, PSG had been named as a defendant in a civil action initiated in the Superior Court Department in Hampden County, Commonwealth of Massachusetts by The Vince Group, Inc. ("TVG"). The case was then removed to the United States District Court for the District of Massachusetts at the request of the parties. The complaint claimed that PSG was obligated to pay a percentage of certain of its revenues to TVG in consideration for a strategic business introduction allegedly made by an agent of TVG. PSG denied the allegations and filed an answer in the litigation. On April 20, 2006, the action was reported settled to the Court, and on June 20, 2006 a Stipulation of Dismissal with Prejudice was filed.



## MANAGEMENT

## Directors and Executive Officers

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

NAME	AGE	POSITIONS HELD
Thomas J. Colatosti	59	Chairman of the Board of Directors
Michael W. DePasquale	52	Chief Executive Officer and Director
Jeffrey J. May (b)	47	Director
Charles P. Romeo(a)	65	Director
John Schoenherr (b)	54	Director
Francis J. Cusick	52	Chief Financial Officer
Randy Fodero	48	Vice President of Sales
Kenneth S. Souza	52	General Manager, Law Enforcement and Chief Technology Officer

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

(b) Audit Committee Member

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

**THOMAS J. COLATOSTI** has served as a Director of the Company since September 2002 and as Chairman of the Board since January 3, 2003. He served as Co-Chief Executive Officer of the Company from July 2005 to August 2006. Mr. Colatosti also currently serves as the Chief Executive Officer of American Security Ventures, a Lexington, Massachusetts based consulting firm he founded which specializes in providing strategic management consulting services to emerging and developing companies in the homeland security industry. From 1997 through June 2002, Mr. Colatosti served as the Chief Executive Officer of Viisage Technology, Inc., a publicly traded biometric technology company focusing on biometric face-recognition technology and delivering highly secure identification documents and systems. Between 1995 and 1997, Mr. Colatosti served as President and Chief Executive Officer of CIS Corporation, a higher education industry leader that designed and implemented integrated and flexible systems solutions to manage entire university administrative operations. Prior to CIS, Mr. Colatosti had a 21 year career with Digital Equipment Corporation. His most recent responsibility was Vice President and General Manager, Northeast Area, where he was responsible for a business unit with annual revenues of more than \$1.2 billion and 3,000 people. Mr. Colatosti is an active industry security spokesperson testifying before Congressional Committees and advising the White House and other Federal security agencies on homeland security issues. Since August 18, 2005, Mr. Colatosti has served as a Director and Chief Financial Officer of Good Harbor Partners Acquisition Corp., a publicly-traded blank check company formed to acquire businesses in the security sectors. Mr. Colatosti earned a Bachelor of Science degree in Management and Finance as well as a Masters degree in Business Administration from Suffolk University.

**MICHAEL W. DEPASQUALE** has served as the Chief Executive Officer and a Director of the Company since January 3, 2003. He served as Co-Chief Executive Officer of the Company from July 2005 to August 2006. Mr. DePasquale brings more than 20 years of executive management, sales and marketing experience to the Company. Prior to joining the Company, Mr. DePasquale served as the President and Chief Executive Officer of Prism eSolutions, Inc., a Pennsylvania based provider of professional consulting services and online solutions for ISO-9001/14000 certification for customers in manufacturing, healthcare and government markets, since February 2001. From December 1999 through December 2000, Mr. DePasquale served as Group Vice President for WRC Media, a New

York based distributor of supplemental education products and software. From January 1996 until December 1999, Mr. DePasquale served as Senior Vice President of Jostens Learning Corp., a California based provider of multi media curriculum. Prior to Jostes, Mr. DePasquale held sales and marketing management positions with McGraw-Hill and Digital Equipment Corporation. Mr. DePasquale earned a Bachelor of Science degree from the New Jersey Institute of Technology.

**JEFFREY J. MAY** has served as a Director of the Company since October 29, 2001. Since December 2006, Mr. May has served as the CEO of MagnaLynx, a semiconductor manufacturer specializing in high speed chip to chip communication. 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-found 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.

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

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

**FRANCIS J. CUSICK** has served as the Chief Financial of the Company since February 28, 2005. Mr. Cusick joined the Company as the Corporate Controller in September 2004. Mr. Cusick served as an independent business consultant to public and private companies in a variety of strategic and financial executive roles from March 2002 until September 2004. From January 2001 through February 2002, Mr. Cusick was Chief Financial Officer for SANgate Systems, a multi-national provider of storage hardware and software. Prior to SANgate Systems, Mr. Cusick held senior financial management positions at Equipe Communications Corp., Parametric Technology Corp., Cascade Communications Corp. and Synernetics Inc.

**RANDY FODERO** has served as the Vice President of Sales since February 1, 2006. From July 22, 2005 until February 1, 2006, he was a sales consultant to the Company. Between July 18, 2003 and July 22, 2005, Mr. Fodero was the Vice President of Sales and Marketing of the Company. Mr. Fodero joined the Company as a member of the sales organization in March 2003. Mr. Fodero brings more

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

**KENNETH S. SOUZA** has served as Executive Vice President and General Manager, Law Enforcement since October 18, 2005. From October 4, 2004 to October 17, 2005 Mr. Souza was Chief Technology Officer of the Company. Prior to joining the Company, Mr. Souza was Vice President of Industry Solutions for EMC Corporation. Prior to joining EMC, he was Vice President for e-Commerce Enterprise Systems Solutions for Compaq Computer Corporation for 4 years. His 25-year technology and market career includes serving in a number of executive positions with Digital Equipment Corporation including Vice President Worldwide Solutions Services and Training, and Director of Workstations Marketing. In the early 1980's, Mr. Souza held technical sales management positions with Hewlett Packard and Burroughs. Mr. Souza also held executive positions with a venture funded MRP software company.

#### **Directors' Terms of Office**

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

## EXECUTIVE COMPENSATION

The following table sets forth a summary of the compensation paid to or accrued by our co-chief executive officers (principal executive officers) and the two most highly compensated executive officers other than the principal executive officers, who were serving as executive officers at the end of December 31, 2006, for the fiscal year ended December 31, 2006:

## SUMMARY COMPENSATION TABLE

Name	Fiscal Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
<b>Michael W. DePasquale(1)</b> Co-Chief Executive Officer	2006	250,000			85,892(6)				335,892
<b>Thomas J. Colatosti(2)</b> Co-Chief Executive Officer	2006	174,000							174,000
<b>Randy Fodero(3)</b> Vice President Sales	2006	256,803(4)			95,633(6)				352,436
<b>Kenneth S. Souza(5)</b> General Manager, Law Enforcement and Chief Technology Officer	2006	200,000	10,000		114,943(6)				324,943

(1) Mr. DePasquale became employed as the Chief Executive Officer on January 3, 2003.

(2) Mr. Colatosti served as Co-Chief Executive Officer from July 2005 to August 2006.

(3) Mr. Fodero became Vice President of Sales on February 1, 2006. He was a sales consultant to the Company from July 22, 2005 until February 1, 2006. Between July 18, 2003 and July 22, 2005, Mr. Fodero was the Senior Vice President of Sales and Marketing of the Company.

(4) Includes \$85,870 of commission income.

(5) Mr. Souza became an executive officer of the Company on October 4, 2004.

(6) The aggregate grant date fair value of the option awards was estimated using the Black-Scholes option pricing model, with the assumptions listed in Note A to the Company's financial statements. The amount shown in this column represents the compensation cost of awards recognized during the year for financial reporting purposes under FAS 123(R), without regard to estimated forfeitures related to service-based vesting conditions for option awards.

## Narrative Disclosure to Summary Compensation Table

*Employment Agreements*

**MICHAEL W. DEPASQUALE.** On March 28, 2006, the Company entered into a two-year employment agreement with Michael W. DePasquale to serve as the Chief Executive Officer of the Company at an annual base salary of \$250,000, subject to adjustment by the Board of Directors, as well as \$1,000 per month in lieu of participating in the Company's medical plan. In addition to the Base Salary and Stock Options, a "Discretionary Bonus" may be awarded to Mr. DePasquale on the basis of merit performance on an annual basis in the sole discretion of the

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Board of Directors. The employment agreement also provides for the grant of options to purchase up to 400,000 shares of Company common stock payable at the discretion of the Board of Directors.

The employment agreement contains standard and customary confidentiality, non-solicitation and "work made for hire" provisions as well as a covenant not to compete which prohibits Mr. DePasquale from doing business with any current or prospective customer of the Company or engaging in a business competitive with that of the Company during the term of his employment and for the one year

period thereafter. This agreement also contains a number of termination and change of control provisions as described in "Termination and Change in Control Arrangements" in this Item.

**THOMAS J. COLATOSTI.** In connection with his appointment to the Board of Directors in September 2002, the Company entered into a number of consulting arrangements with Thomas J. Colatosti. Under the most recent arrangement, which was entered into on February 7, 2006, Mr. Colatosti provided services to the Company and its subsidiaries and affiliates for the year ended December 31, 2006 at a rate of \$14,500 per month. This agreement expired on December 31, 2006 and has not been renewed.

**KENNETH S. SOUZA.** In connection with his appointment as Senior Vice President and Chief Technology Officer of the Company on October 4, 2004, we entered into a one year employment agreement with Kenneth S. Souza. The employment agreement provides for an annual base salary of \$200,000 and a performance bonus in the amount of up to \$76,000 payable upon achievement of certain performance criteria. Unless notice of non-renewal is provided to Mr. Souza at least two months prior to the end of the term, the employment agreement automatically renews for successive one year terms. This agreement also contains a number of termination and change of control provisions as described in "Termination and Change in Control Arrangements" in this Item.

***Stock Option Grant***

On March 23, 2006, Michael DePasquale, Randy Fodero, and Kenneth Souza were granted options to purchase 400,000, 100,000, and 250,000 shares of common stock respectively, at an exercise price of \$0.75 per share. These options expire on March 23, 2016. The options vest in equal increments over two years, as described in "Outstanding Equity Awards at Fiscal Year End" in this Item.

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

**OUTSTANDING EQUITY AWARDS AT FISCAL YEAR END DECEMBER 31, 2006**

The following table sets forth for each named executive officer, information regarding outstanding equity awards as at December 31, 2006:

Name	Option Awards				Stock Awards				
	Number of securities underlying unexercised options exercisable (#)	Number of securities underlying unexercised options unexercisable (#)	Equity incentive plan awards: Number of securities underlying unexercised options (#)	Option exercise price (\$)	Option expiration date	Number of shares or units of stock that have not vested (#)	Market value of shares or units of stock that have not vested (\$)	Equity incentive plan awards: Number of unearned shares or units or other rights that have not vested (#)	Equity incentive plan awards: Market or payout value of unearned shares, units or other rights that have not vested (\$)
Michael W. DePasquale	500,000			1.32	12/11/2010				
	580,000			0.53	1/3/2010				
		400,000(1)		0.75	3/23/2013				
Thomas J. Colatosti	200,000			0.31	8/28/2009				
	150,000			0.31	8/28/2009				
	50,000			1.32	12/11/2010				
	150,000			1.32	12/11/2010				
Randy Fodero	333,333	266,667(2)		0.60	11/11/2012				
		100,000(3)		0.75	3/23/2013				
Kenneth S. Souza	200,000	100,000(4)		1.05	9/15/2011				
		250,000(5)		0.75	3/23/2013				

- (1) The options vest equally in two annual installments commencing March 23, 2007; 200,000 vested on March 23, 2007 and 200,000 will vest on March 23, 2008.
- (2) 200,000 of the options vested upon grant and the remaining options vest equally thereafter in three annual installments commencing November 11, 2006; 133,333 vested on November 11, 2006, 133,333 will vest on November 11, 2007 and 133,334 will vest on November 11, 2008.
- (3) The options vest equally in two annual installments commencing March 23, 2007; 50,000 vested on March 23, 2007 and 50,000 will vest on March 23, 2008.
- (4) The options vest equally in three annual installments commencing October 4, 2005; 100,000 vested on October 4, 2005; 100,000 vested on October 4, 2006 and 100,000 will vest on October 4, 2007.
- (5) The options vest equally in two annual installments commencing March 23, 2007; 125,000 vested on March 23, 2007 and 125,000 will vest on March 23, 2008.

**Termination and Change in Control Arrangements**

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

*Termination Arrangements*

**MICHAEL W. DEPASQUALE employment agreement.** On March 28, 2006, the Company entered into a two-year employment agreement with Michael W. DePasquale to serve as the Chief Executive Officer of the Company.

The Company may terminate the agreement at any time with or without cause. In the event of termination without cause, Mr. DePasquale shall continue to be paid his then current base salary for six months from the date of such termination.

**KENNETH S. SOUZA employment agreement.** On October 4, 2006, the Company renewed the annual agreement with Kenneth Souza to serve as Executive Vice President and General Manager, Law Enforcement of the Company.



The Company may terminate the agreement at any time with or without cause. In the event of termination without cause, Mr. Souza shall continue to be paid his then current base salary for the greater of six months from the date of such termination or the number of months remaining until the end of the term of the employment agreement.

*Change in Control Provisions*

The Company's 1996 Stock Option Plan (as amended to date, the "1996 Plan"), 1999 Stock Option Plan and 2004 Stock Incentive Plan (the "1999 Plan" and together with the 1996 Plan and 2004 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" each Plan provides 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 which are neither assumed or substituted in connection with such transaction, automatically expire unless otherwise determined by the Board. 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 any or all optionees equal to the difference between the exercise price of any or all such options and the fair market value of the Company's common stock immediately prior to the Change In Control. The 2004 Plan enables the Board to provide that all outstanding options be assumed, or equivalent options be substituted by the acquiring or succeeding corporation upon the occurrence of a "Reorganization Event" as defined. If such Reorganization Event also constitutes a Change in Control, then such assumed or substituted options shall be immediately exercisable in full. If the acquiring or succeeding corporation does not agree to assume, or substitute for such options, then the Board, upon written notice to the Participants, may provide that all unexercised options become exercisable in full as of a specified time prior to the Reorganization Event and terminate prior to the consummation of the Reorganization Event. Alternatively, if under the terms and conditions of the Reorganization Event, holders of common stock will receive a cash payment for their shares, then the Board may provide that all Participants receive a cash payment equal to the difference between the Acquisition Price and the Option Price multiplied by the number of options held by such Participants.

Options issued to executive officers outside of the Plans contain change in control provisions substantially similar to those contained in the 1999 Plan.

**DIRECTOR COMPENSATION FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006**

The following table sets forth for each director, information regarding their compensation for the year ended December 31, 2006:

Name	Fees Earned or Paid in Cash (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
Thomas J. Colatosti(1)							
Michael W. DePasquale(1)							
Jeffrey J. May							
Charles P. Romeo			112,978(2)				112,978
John Schoenherr			20,053(2)				20,053

(1) Refer narrative disclosure to summary compensation table for information pertaining to employment agreements.

(2) The aggregate grant date fair value of the option awards was estimated using the Black-Scholes option pricing model, with the assumptions listed in Note A to the Company's financial statements. The amount shown in this column represents the compensation cost of awards recognized during the year for financial reporting purposes under FAS 123(R), without regard to estimated forfeitures related to service-based vesting conditions for option awards.

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

**Code of Ethics**

We have adopted a Code of Ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. Our Code of Ethics is designed to deter wrongdoing and promote: (i) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (ii) full, fair, accurate, timely and understandable disclosure in reports and documents that we file with, or submit to, the SEC and in our other public communications; (iii) compliance with applicable governmental laws, rules, and regulations; (iv) the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (v) accountability for adherence to the code. Any person may obtain a copy of our Code of Ethics free of charge by sending a written request for such to the attention of the Chief Financial Officer of the Company, 3349 Highway 138, Building D Suite B, Wall, NJ 07719.

**Internet Address and SEC Reports**

We maintain a website with the address [www.BIO-key.com](http://www.BIO-key.com). We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-KSB. We make available free of charge through our website our Annual Reports on Form 10-KSB, Quarterly Reports on Form 10-QSB and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the SEC. Our SEC filings and Code of Ethics are also available over the internet at the SEC's website [www.sec.gov](http://www.sec.gov). Members of the public may read and copy any materials the Company files with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the public reference room is available by calling the SEC on 1800-SEC-0330.

## **CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

### **Employment Arrangements**

The Company has entered into an employment agreements with Michael W. DePasquale and Kenneth S. Souza. See "**EXECUTIVE COMPENSATION Employment Agreements.**"

### **Options Granted to Executive Officers and Directors**

During 2006 and 2005, the Company issued options to purchase an aggregate of 900,000 and 1,155,000 shares, respectively of common stock to its officers and directors. The 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 a term of seven years, and vest over a two to three year period.

### **Consulting Arrangement with Thomas J. Colatosti**

In connection with his appointment to the Board of Directors in September 2002, the Company entered into a number of consulting arrangements with Thomas J. Colatosti. Under the most recent arrangement, which was entered into on February 7, 2006, Mr. Colatosti provided services to the Company and its subsidiaries and affiliates for the year ended December 31, 2006 at a rate of \$14,500 per month.

### **Equity raising with Trellus Partners, LP ("Trellus")**

Trellus may be deemed to be a "related person" under Item 404 of Regulation S-B by virtue of its ownership of more than five percent of the Company's outstanding common stock. As further discussed in this Report, including in the "Management's Discussion and Analysis or Plan of Operation" section, pursuant to the August 10, 2006 Securities Purchase Agreement with Trellus, the Company issued and sold 3,000,000 shares of its Common Stock to Trellus, at a purchase price of \$0.50 per share, for an aggregate purchase price of \$1,500,000.

**SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The following table sets forth, as of March 1, 2007, information with respect to the securities holdings of all persons which the Company, pursuant to filings with the Securities and Exchange Commission, has reason to believe may be deemed the beneficial owners of more than five percent (5%) of the Company's outstanding common stock. The following table also sets forth, as of such date, the beneficial ownership of the Company's common stock by all officers and directors, individually and as a group. Unless otherwise indicated, the address of each person listed below is c/o BIO-key International, Inc., 3349 Highway 138, Building D, Suite B, Wall, NJ 07719

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership(1)	Percentage of Class(1)
Thomas J. Colatosti	1,080,000(2)	1.9%
Michael W. DePasquale	1,300,000(3)	2.3%
Francis J. Cusick	208,331(4)	*
Jeffrey May	250,000(5)	*
Charles P. Romeo	325,000(6)	*
John Schoenherr	50,000(7)	*
Randy Fodero	383,333(8)	*
Kenneth S. Souza	325,000(9)	*
Kingdon Capital Management, LLC 152 West 57 <sup>th</sup> Street 50 <sup>th</sup> Floor New York, NY 10019	2,696,112	4.8%
Trellus Management Company, LLC 350 Madison Avenue 9 <sup>th</sup> Floor New York, NY 10017	8,922,239	15.8%
All officers and directors as a group (8) persons	3,921,664	6.9%

\*  
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 56,591,104 shares of common stock outstanding as of March 1, 2007.
- (2) Includes 550,000 shares assumable upon exercise of options and 525,000 shares issuable upon conversion of series A preferred stock.
- (3) Includes 1,280,000 shares issuable upon exercise of options. Does not include 200,000 shares issuable upon exercise of options subject to vesting.
- (4) Includes 208,331 shares issuable upon exercise of options. Does not include 141,669 shares issuable upon exercise of options subject to vesting.
- (5) Consists of shares issuable upon exercise of options.
- (6) Includes 325,000 shares issuable upon exercise of options. Does not include 75,000 shares issuable upon exercise of options subject to vesting.
- (7) Consists of shares issuable upon exercise of options.



- (8) Includes 383,333 shares issuable upon exercise of options. Does not include 316,667 shares issuable upon exercise of options subject to vesting.
- (9) Includes 325,000 shares issuable upon exercise of options. Does not include 225,000 shares issuable upon exercise of options subject to vesting.

The following table sets forth, as of December 31, 2006, information with respect to securities authorized for issuance under equity compensation plans.

**EQUITY COMPENSATION PLAN INFORMATION**

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	125,000	\$ 0.47	
Equity compensation plans not approved by security holders	8,009,419	\$ 0.86	1,817,838
<b>Total</b>	<b>8,134,419</b>	<b>\$ 0.85</b>	<b>1,817,838</b>

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 1996 Plan terminated in May 2005.

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

The 1999 Plan is currently administered by the Board of Directors of the Company (the "Plan Administrator"). The Plan Administrator is authorized to construe the 1999 Plan and any option issued under the 1999 Plan, select the persons to whom options may be granted, and determine the number of shares to be covered by any option, the exercise price, vesting schedule and other material terms of such option.

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

The 1999 Plan provides for the immediate vesting of all options in the event of a "Change In Control" of the Company. In the event of a Change In Control, the Company is required to deliver

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

As of December 31, 2006, there were outstanding options under the 1996 Plan to purchase 125,000 shares of common stock, and no shares were available for future grants.

As of December 31, 2006, there were outstanding options under the 1999 Plan to purchase 995,000 shares of common stock, and options to purchase an aggregate of 714,257 shares were available for future grants.

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

As of December 31, 2006, there were outstanding options under the 2004 Plan to purchase 2,896,419 shares of common stock, and options to purchase an aggregate of 1,103,581 shares were available for future grants.

In addition to options issued under the 1996, 1999 and 2004 Plans, the Company has issued options to employees, officers, directors and consultants to purchase common stock under the non plan. As of December 2006, there were outstanding options under the non plan to purchase 4,118,000 shares of common stock. The terms of these options are substantially similar to the provisions of the 1999 Plan and options issued thereunder.

**DESCRIPTION OF SECURITIES**

**Common Stock**

The Company is authorized to issue 170,000,000 shares of common stock, \$.0001 par value per share, of which 56,591,104 were outstanding as of March 1, 2007.

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

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

**Convertible Preferred Stock**

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

**Series A Convertible Preferred Stock.**

In March 2004, we designated 100,000 shares of preferred stock as Series C Convertible Preferred Stock. In connection with the Company's reincorporation in Delaware, each share of Series C Convertible Preferred Stock was automatically converted into one share of Series A Convertible Preferred Stock (the "Series A Shares"), of which 30,557 were issued and outstanding December 31, 2006. The following describes the material provisions of the Series A Shares which are more fully set forth in the Certificate of Designation on file with the Delaware Secretary of State.

The Series A Shares accrue a cumulative annual dividend of 7% on the \$100 face amount of such shares payable June 15 and December 15 each year in shares of common stock. In the event of a liquidation, dissolution or winding up of the Company, the Series A shares have a liquidation preference of \$100 per share (plus all accrued and unpaid dividends thereon) prior to any payment or distribution to holders of our common stock. The Series A Shares are convertible into common stock at a conversion price of \$.50 per share. The conversion price is subject to proportional adjustment in the event of stock splits, stock dividends or reclassifications. Subject to certain exceptions, in the event we issue additional shares of common stock at a purchase price less than the conversion price of the Series A Shares, the conversion price shall be lowered to such lesser price. In the event that the average closing bid price of our common stock is less than \$1.00 per share for thirty (30) consecutive trading days at any time after March 3, 2008, we will be required to redeem the Series A Shares by payment of \$100 per share plus all accrued and unpaid dividends due thereon. This date was deferred from March 3, 2007 to March 3, 2008 by an agreement with the holders of the Series A Shares on March 28, 2007.

We are required to obtain the consent of the holders of a majority of the Series A Shares in order to, among other things, issue any shares of preferred stock that are equal to or have a preference over the Series A shares or issue any shares of preferred stock, rights, options, warrants, or any other securities convertible into common stock of the Company, other than those issued to employees of the Company in the ordinary course of their employment or to consultants or other persons providing services to the Company so long as such issuances do not exceed 500,000 shares of common stock. We



are also required to obtain such consent in order to, among other things, complete a sale or other disposition of any material assets, complete an acquisition of a material amount of assets, engage in a merger, reorganization or consolidation, or incur or guaranty any indebtedness in excess of \$50,000.

**Series B Convertible Preferred Stock.**

In January 2006, the Company designated 1,000,000 shares of preferred stock as Series B Convertible Preferred Stock, all of which are issued and outstanding as of December 31, 2006. The following describes the material provisions of the Series B Convertible Preferred Shares which are more fully set forth in the Certificate of Designation on file with the Delaware Secretary of State.

The Series B Convertible Preferred Shares accrue a cumulative annual dividend of 15% on the \$1 face amount of such shares payable January 1, April 1, July 1 and October 1 each year in shares of common stock, or cash at the Company's election. In the event of a liquidation, dissolution or winding up of the Company, the Series B Convertible Preferred Shares have a liquidation preference of \$1 per share (plus all accrued and unpaid dividends thereon) prior to any payment or distribution to holders of our common stock. The Series B Convertible Preferred Shares are convertible into common stock at a conversion price of \$.50 per share. The conversion price is subject to proportional adjustment in the event of stock splits, stock dividends or reclassifications. Subject to certain exceptions, in the event we issue additional shares of common stock at a purchase price less than the conversion price of the Series B Convertible Preferred Shares, the conversion price shall be lowered to such lesser price.

If during the thirty (30) consecutive trading day period occurring prior to January 1, 2009, the average closing bid price for one share of Common Stock, as reported by Bloomberg, L.P. is at least \$1.10, all outstanding Series B shares shall automatically be converted into Common Stock, at the then effective conversion rate. Upon conversion, all accrued or declared but unpaid dividends on the Series B shares shall be paid in shares of Common Stock. In the event that the average closing bid price of our common stock is less than \$1.10 per share for thirty (30) consecutive trading days at any time after January 1, 2009, we will be required to redeem the Series B Convertible Preferred Shares by payment of \$1 per share plus all accrued and unpaid dividends due thereon.

For as long as twenty-five percent (25%) of the Series B Convertible Preferred Stock are outstanding, we are required to obtain the consent of the holders of a majority of the Series B Convertible Preferred Shares in order to, among other things, issue any shares of preferred stock that are equal to or have a preference over the Series B Convertible Preferred Shares or issue any shares of preferred stock, rights, options, warrants, or any other securities convertible into common stock of the Company, other than those issued to employees of the Company in the ordinary course of their employment or to consultants or other persons providing services to the Company. We are also required to obtain such consent in order to, among other things, complete a sale or other disposition of any material assets, complete an acquisition of a material amount of assets, engage in a merger, reorganization or consolidation, or incur or guaranty any indebtedness in excess of \$50,000.

**Series C Convertible Preferred Stock.**

In August 2006, the Company designated 600,000 shares of preferred stock as Series C Convertible Preferred Stock, 592,032 of which are issued and outstanding, as of December 31, 2006. The following describes the material provisions of the Series C Convertible Preferred Shares, which are more fully set forth in the Certificate of Designation on file with the Delaware Secretary of State.

The Series C Convertible Preferred Shares accrue a cumulative annual dividend of 15% on the \$10 face amount of such shares payable December 1, March 1, June 1 and September 1 each year in shares of common stock, or cash at the Company's election. In the event of a liquidation, dissolution or winding up of the Company, the Series C Convertible Preferred Shares have a liquidation preference of \$10 per share (plus all accrued and unpaid dividends thereon) prior to any payment or distribution to

holders of our common stock. The Series C Convertible Preferred Shares are convertible into common stock at a conversion price of \$.50 per share. The conversion price is subject to proportional adjustment in the event of stock splits, stock dividends or reclassifications. Subject to certain exceptions, in the event we issue additional shares of common stock at a purchase price less than the conversion price of the Series C Convertible Preferred Shares, the conversion price shall be lowered to such lesser price.

If during the thirty (30) consecutive trading day period occurring prior to January 1, 2009, the average closing bid price for one share of Common Stock, as reported by Bloomberg, L.P. is at least \$1.20, all outstanding Series C shares shall automatically be converted into Common Stock, at the then effective conversion rate. Upon conversion, all accrued or declared but unpaid dividends on the Series C shares shall be paid in shares of Common Stock. In the event that the average closing bid price of our common stock is less than \$1.20 per share for thirty (30) consecutive trading days at any time after January 1, 2009, we will be required to redeem the Series C Convertible Preferred Shares by payment of \$10.00 per share plus all accrued and unpaid dividends due thereon.

For as long as any of the Series C Convertible Preferred Stock are outstanding, we are required to obtain the consent of the holders of the Series C Convertible Preferred Shares in order to, among other things, issue any shares of preferred stock that are equal to or have a preference over the Series C Convertible Preferred Shares or issue any shares of preferred stock, rights, options, warrants, or any other securities convertible into common stock of the Company, other than those issued to employees of the Company in the ordinary course of their employment or to consultants or other persons providing services to the Company.

#### **Dividend Policy**

The Company has never paid cash dividends on its common stock. The Board of Directors does not anticipate paying cash dividends in the foreseeable future as it intends to retain future earnings, if any, to finance the growth of the business. The payment of future dividends will depend on such factors as earnings levels, anticipated capital requirements, the operating and financial condition of the Company and other factors deemed relevant by the Board of Directors.

#### **Anti-Takeover Provisions of the Company's Certificate of Incorporation**

As described above, the Board of Directors is authorized without further stockholder action, to designate any number of series of preferred stock with such rights, preferences and designations as determined by the Board. Shares of preferred stock issued by the Board of Directors could be utilized, under certain circumstances, to make an attempt to gain control of the Company more difficult or time consuming. For example, shares of preferred stock could be issued with certain rights that might have the effect of diluting the percentage of common stock owned by a significant stockholder or issued to purchasers who might side with management in opposing a takeover bid that the Board of Directors determines is not in the best interest of the Company and its stockholders. The existence of the preferred stock may, therefore, be viewed as having possible anti-takeover effects.

#### **Transfer Agent**

The transfer agent for the Company's common stock is StockTrans, Inc., 44 West Lancaster Avenue, Ardmore, Pennsylvania 19003, (610) 649-7300.

### **ACQUISITION OF AETHER MOBILE GOVERNMENT**

On September 30, 2004, we completed our acquisition from Aether of its Mobile Government Division. Pursuant to the Asset Purchase Agreement dated as of August 16, 2004 by and among the Company, Aether, Cerulean Technology, Inc. and SunPro, Inc., the Company paid Aether a purchase price of \$10,000,000 in cash, subject to post-closing adjustments to reflect changes in Aether Mobile

Government's working capital since June 30, 2004. In connection with this acquisition, the Company issued a Subordinated Secured Promissory Note to Aether in the face amount of \$6,884,588 (the "Aether Note"). The Aether Note evidences a contingent reimbursement obligation of the Company to Aether and a surety fee payable by the Company to Aether, in each case with respect to a letter of credit maintained by Aether for the Company's benefit in connection with the acquisition. The Company's obligations under the Aether Note are secured by a security interest granted to Aether in all or substantially all of the Company's assets, subordinate to the security interest described in the "Convertible Debt Financing Transactions" section of this prospectus below.

Aether Mobile Government provides wireless data solutions for use by public safety organizations, primarily state and local police, fire and rescue and emergency medical services organizations, that enable such organizations to access law enforcement databases to validate identities and obtain suspect information. Its public safety solutions are integrated into fifty (50) different state databases, as well as local and federal databases, and its products deliver real-time information in seconds, without the need for human dispatchers or other resources. Upon completing the purchase of Aether Mobile Government, we acquired its principal products, which are:

The PacketCluster® family of products, which are open, standards-based wireless information software products that provide police officers in the field with direct access to motor vehicle and warrant information and other critical information;

The handheld version of PacketCluster® Patrol (called PocketBlue), which is a handheld application for mobile law enforcement that is part of a fully integrated mobile data system, providing criminal database queries, secure messaging and alarm capabilities for all connected mobile users;

PacketWriter, which is a mobile field reporting solution that allows for mobile data collection, data sharing with PacketCluster® and work-flow management;

The FireRMS family of products for fire and rescue companies, which are compliant incident reporting products specifically developed to cut report completion time for front-line emergency response personnel; and

Handheld applications for fire and rescue companies (PocketFD and PacketCluster Rescue), which allow fire services personnel to wirelessly access and update records in the field and extends computer aided dispatch, fire records management systems and other in-house data sources to a mobile environment.

## FINANCING TRANSACTIONS

### Secured Debt Financing

On September 29, 2004, we entered into a Securities Purchase Agreement (the "Senior Purchase Agreement") with Laurus Master Fund, Ltd. ("Laurus") and certain other institutional and accredited investors (together with Laurus, the "Senior Investors"). Under the Senior Purchase Agreement, the Company issued secured convertible term notes (the "Senior Convertible Notes") in the aggregate principal amount of \$5,050,000, convertible into common stock of the Company in certain circumstances at an initial conversion price of \$1.35 per share, and issued warrants (the "Senior Warrants") to purchase an aggregate of 1,122,222 shares of our common stock at an initial exercise price of \$1.55 per share. The proceeds from this transaction were used in part to finance the Company's acquisition of Aether Mobile Government (the "Aether Acquisition"). The Company's obligations under the Senior Purchase Agreement, the Senior Convertible Notes and the Senior Warrants are secured by a security interest in all or substantially all of the Company's assets.

Under the terms of the Senior Convertible Notes, we are required to make monthly payments of accrued interest only beginning on November 1, 2004. In addition, the Senior Convertible Notes provide for monthly payments of principal in equal  $\frac{1}{32}$  increments thereof, plus accrued interest, commencing February 1, 2005. The Senior Convertible Notes bear interest at an initial rate equal to the prime rate plus two percent (2%), subject to a six percent (6%) floor. The interest rate on the Senior Convertible Notes is subject to reduction on a month-by-month basis if specified conditions are met. In particular, if (a) we register the common stock underlying the Senior Convertible Notes and Senior Warrants on a registration statement declared effective by the Securities and Exchange Commission and (b) our common stock is trading at a 25% or greater premium to the note conversion price, then the interest rate will be adjusted downward by 2.0% for each incremental 25% increase over the note conversion price. Alternatively, if (x) we have not registered such common stock under an effective registration statement, but (y) our common stock is trading at a 25% or greater premium to the note conversion price, then the interest rate will be adjusted downward by 1.0% for each incremental 25% increase over the note conversion price.

For any cash payments we make on the Senior Convertible Notes (e.g., any amounts due that are not converted into common stock), we are required to pay an amount equal to 102% of the principal amount due. In addition, we can prepay the note at any time upon payment of an amount equal to 110% of the then outstanding principal balance, plus accrued and unpaid interest.

The Senior Investors have the option at any time to convert any or all of the outstanding principal and accrued and unpaid interest on the Senior Convertible Notes into shares of our common stock at a conversion price of \$0.50 per share. In addition, for each monthly payment under the note, the Senior Investors will be obligated to convert a portion of the monthly payment into common stock at the applicable conversion price, so long as:

the average closing price of our common stock (for the five trading days immediately preceding the payment date) is greater than \$0.55 per share (which represents 110% of the note conversion price, based on the conversion price of \$0.50),

such amount being converted does not exceed 25% of the aggregate dollar trading volume for such immediately preceding twenty-two trading days, and

the shares of common stock underlying the note are registered under an effective registration statement with the Securities and Exchange Commission.

The terms of the Senior Convertible Notes and Senior Warrants prohibit conversion of the notes or exercise of the warrants to the extent that conversion of the notes and exercise of the warrants would result in any holder thereof, together with its affiliates, beneficially owning in excess of 4.99% of our outstanding shares of common stock. A holder may waive the 4.99% limitation upon 75 days' prior written notice to us. Also, this limitation does not preclude the holder from converting or exercising the note or warrant and selling shares underlying the note or warrant in stages over time where each stage does not cause the holder and its affiliates to beneficially own shares in excess of the limitation amount.

As security for our obligations to the Senior Investors, we, along with our wholly-owned subsidiary Public Safety Group, Inc. ("PSG"), granted to the Senior Investors a blanket security interest in all of our assets, and we entered into a stock pledge with the Senior Investors for the capital stock in PSG. If an event of default occurs under the Senior Convertible Notes or the other related investment agreements, 120% of the unpaid principal balance on the Senior Convertible Notes, plus accrued interest and fees, shall become immediately due and the Senior Investors shall be entitled to payment

of a default interest rate of 1.5% per month on all amounts due under the Senior Convertible Notes. Such events of default include the following:

a failure to pay interest and principal payments under the Senior Convertible Notes within three days of when due;

a breach by us of any material covenant or term or condition of the Senior Convertible Notes or in any of the investment agreements, if not cured within 30 days of such breach;

a breach by us of any material representation or warranty made in the Senior Convertible Notes or in any of the investment agreements;

if we make an assignment for the benefit of our creditors, or a receiver or trustee is appointed for us, or any form of bankruptcy or insolvency proceeding is instituted by us, or any involuntary proceeding is instituted against us if not vacated within 60 days;

the filing of any money judgment or similar final process against us for more than \$50,000, which remains unvacated, unbonded or unstayed for a period of 30 days;

if our common stock is suspended for five consecutive days or for five days during any ten consecutive days from a principal market or pursuant to a Securities and Exchange Commission stop order; and

a failure by us to timely deliver shares of common stock when due upon conversions of the Senior Convertible Notes.

Upon an event of default, the Senior Lenders will be entitled to specified remedies, including remedies under the Uniform Commercial Code.

We have agreed to register with the Securities and Exchange Commission for resale the shares of common stock that are issuable upon conversion of the Senior Convertible Notes and upon exercise of the Senior Warrants. Under the registration rights agreement, we are obligated to file a registration statement with the Securities and Exchange Commission on or before October 29, 2004, and to use reasonable commercial efforts to have the registration statement declared effective not later than December 28, 2004. The resale registration statement of which this prospectus is a part was initially filed with the Securities and Exchange Commission on October 29, 2004 for the shares underlying the Senior Convertible Notes and Senior Warrants, and became effective as of December 28, 2004. If we fail to comply with our registration obligations, the Senior Investors will be entitled to certain specified remedies, including monetary liquidated damages. In particular, for each 30 days (or such pro rated number of days) that we are out of compliance with our registration obligations, we will be subject to a liquidated damage assessment of 2% of the then outstanding principal amount of the Senior Convertible Notes.

Each Senior Investor has agreed, pursuant to the Senior Purchase Agreement, that neither it nor any of its affiliates and investment partners will (and will not cause any other person or entity, directly or indirectly, to) engage in "short sales" of our common stock for as long as any Senior Convertible Notes held by it remain outstanding. "Short sales" are contracts for the sale of shares of stock that the seller does not own, or certificates which are not within the seller's control, so as to be available for delivery at the time when, under applicable rules, delivery must be made.

#### **Subordinated Debt Financing**

On September 29, 2004, we entered into a Securities Purchase Agreement (the "Subordinated Purchase Agreement") with The Shaar Fund, Ltd. ("Shaar") and other existing shareholders of the Company and accredited investors (collectively, the "Subordinated Investors"). Under the Subordinated Purchase Agreement, the Company issued unsecured convertible term notes (the "Subordinated

Convertible Notes") in the aggregate principal amount of \$4,950,000, convertible into common stock of the Company in certain circumstances at an initial conversion price of \$1.35 per share, and issued warrants (the "Subordinated Warrants") to purchase an aggregate of 1,099,997 shares of our common stock at an initial exercise price of \$1.55 per share. The proceeds from this transaction were used in part to finance a portion of the Aether Acquisition and will be used in part for working capital purposes.

Under the terms of the Subordinated Convertible Notes, we are required to make monthly payments of accrued interest only beginning on November 1, 2004. In addition, the Subordinated Convertible Notes provide for monthly payments of principal in equal  $\frac{1}{32}$  increments thereof, plus accrued interest, commencing February 1, 2005, which payments may be made in shares of common stock at the option of each noteholder. The Subordinated Convertible Notes bear interest at an initial rate equal to the prime rate plus seven and one-half percent (7.5%), subject to an eleven percent (11%) floor.

We may prepay the Subordinated Convertible Notes at any time upon payment of an amount equal to 110% of the then outstanding principal balance, plus accrued and unpaid interest. Upon any such prepayment, the Senior Convertible Notes must also be prepaid. The Subordinated Investors have the option at any time to convert any or all of the outstanding principal and accrued and unpaid interest on the Subordinated Convertible Notes into shares of our common stock at an initial conversion price of \$1.35 per share.

The terms of the Subordinated Convertible Notes and Subordinated Warrants prohibit conversion of the notes or exercise of the warrants to the extent that conversion of the notes and exercise of the warrants would result in any holder thereof, together with its affiliates, beneficially owning in excess of 4.99% of our outstanding shares of common stock. A holder may waive the 4.99% limitation upon 75 days' prior written notice to us. Also, this limitation does not preclude the holder from converting or exercising the note or warrant and selling shares underlying the note or warrant in stages over time where each stage does not cause the holder and its affiliates to beneficially own shares in excess of the limitation amount.

If an event of default occurs under the Subordinated Convertible Notes or the other related investment agreements, the unpaid principal balance on the Subordinated Convertible Notes, plus accrued interest, shall, at the noteholder's option, become immediately due and the Subordinated Investors shall be entitled to payment of additional default interest at the rate of 2.0% per month on all amounts due under the Subordinated Convertible Notes. Such events of default include the following:

failure to pay interest and principal payments under the Subordinated Convertible Notes within three days of when due;

a breach by us of any covenant, term or condition in any material respect of the Subordinated Convertible Notes or in any of the investment agreements, if not cured within 30 days of such breach;

any representation or warranty made in the Subordinated Convertible Notes or in any of the investment agreements being false or misleading in any material respect;

if we make an assignment for the benefit of our creditors, or a receiver or trustee is appointed for us, or any form of bankruptcy or insolvency proceeding is instituted by us, or any involuntary proceeding is instituted against us;

the filing of any money judgment or similar final process against us for more than \$50,000, which remains unvacated, unbonded or unstayed for a period of 30 days;

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if our common stock is suspended for five consecutive days or for five days during any ten consecutive days from a principal market or pursuant to a Securities and Exchange Commission stop order;

a failure by us to timely deliver shares of common stock when due upon conversions of the Subordinated Convertible Notes; and

a change in our controlling ownership.

Upon an event of default, the rights and remedies of the Subordinated Investors will be subordinate to those of the Senior Investors pursuant to a Subordination and Intercreditor Agreement dated as of September 30, 2004 by and among Laurus, as Collateral Agent, Shaar, as Purchaser Agent, Aether Systems, Inc., PSG and the Company

We have agreed to register with the Securities and Exchange Commission for resale the shares of common stock that are issuable upon conversion of the Subordinated Convertible Notes and upon exercise of the Subordinated Warrants. Under the registration rights agreement, we are obligated to file a registration statement with the Securities and Exchange Commission on or before October 29, 2004, and to use reasonable commercial efforts to have the registration statement declared effective not later than December 28, 2004. The resale registration statement of which this prospectus is a part was initially filed with the Securities and Exchange Commission on October 29, 2004 for the shares underlying the Subordinated Convertible Notes and Subordinated Warrants, and became effective as of December 28, 2004. If we fail to comply with our registration obligations, the Subordinated Investors will be entitled to certain specified remedies, including monetary liquidated damages. In particular, for each 30 days (or such pro rated number of days) that we are out of compliance with our registration obligations, we will be subject to a liquidated damage assessment of 2% of the then outstanding principal amount of the Subordinated Convertible Notes.

Each Subordinated Investor has agreed, pursuant to the Subordinated Purchase Agreement, that neither it nor any of its affiliates and investment partners will (and will not cause any other person or entity, directly or indirectly, to) engage in "short sales" of our common stock for as long as any Subordinated Convertible Notes held by it remain outstanding.

### **Secured Debt Financing**

On June 8, 2005, we entered into a Securities Purchase Agreement (the "Senior Purchase Agreement") with Laurus Master Fund, Ltd. ("Laurus"). Under the Senior Purchase Agreement, the Company issued a secured convertible term note (the "Senior Convertible Note") in the aggregate principal amount of \$2,000,000, convertible into common stock of the Company in certain circumstances at an initial conversion price of \$0.85 per share, and issued a warrant (the "Senior Warrant") to purchase an aggregate of 444,444 shares of our common stock at an initial exercise price of \$1.00 per share. As consideration for the Senior Convertible Note and Senior Warrant, the Company received approximately \$1,841,000, net of all fees and expenses, from Laurus, which amount was disbursed to the Company on June 9, 2005. The proceeds from this transaction will be used for the Company's general working capital purposes. The Company's obligations under the Senior Purchase Agreement, the Senior Convertible Note and the Senior Warrant are secured by a security interest in all or substantially all of the Company's assets.

Under the terms of the Senior Convertible Note, we are required to make monthly payments of accrued interest only beginning on July 1, 2005. In addition, the Senior Convertible Note provides for monthly payments of principal in equal increments thereof, plus accrued interest, commencing October 1, 2005. The Senior Convertible Note bears interest at an initial rate equal to the prime rate plus two percent (2%), subject to a six percent (6%) floor. The interest rate on the Senior Convertible Note is subject to reduction on a month-by-month basis if the following conditions are met: If (a) we

register the common stock underlying the Senior Convertible Note and Senior Warrant on a registration statement declared effective by the Securities and Exchange Commission and (b) our common stock is trading at a 25% or greater premium to the note conversion price, then the interest rate will be adjusted downward by 2.0% for each incremental 25% increase over the note conversion price. Alternatively, if (x) we have not registered such common stock under an effective registration statement, but (y) our common stock is trading at a 25% or greater premium to the note conversion price, then the interest rate will be adjusted downward by 1.0% for each incremental 25% increase over the note conversion price. In no event shall the interest rate be less than 0%.

For any cash payments we make on the Senior Convertible Note (e.g., any amounts due that are not converted into common stock), we are required to pay an amount equal to 102% of the principal amount due. In addition, we can prepay the note at any time upon payment of an amount equal to 110% of the then outstanding principal balance, plus accrued and unpaid interest.

Laurus has the option at any time to convert any or all of the outstanding principal and accrued and unpaid interest on the Senior Convertible Note into shares of our common stock at a conversion price of \$0.50 per share. In addition, for each monthly payment under the note, Laurus will be obligated to convert a portion of the monthly payment into common stock at the applicable conversion price, so long as:

the average closing price of our common stock (for the five trading days immediately preceding the payment date) is greater than \$0.55 per share (which represents 110% of the note conversion price, based on the conversion price of \$0.50),

such amount being converted does not exceed 25% of the aggregate dollar trading volume for such immediately preceding twenty-two trading days, and

the shares of common stock underlying the note are registered under an effective registration statement with the Securities and Exchange Commission.

The terms of the Senior Convertible Note and Senior Warrant prohibit conversion of the note or exercise of the warrant to the extent that conversion of the note and exercise of the warrant would result in any holder thereof, together with its affiliates, beneficially owning in excess of 4.99% of our outstanding shares of common stock. A holder may waive the 4.99% limitation upon 75 days' prior written notice to us. Also, this limitation does not preclude the holder from converting or exercising the note or warrant and selling shares underlying the note or warrant in stages over time where each stage does not cause the holder and its affiliates to beneficially own shares in excess of the limitation amount.

As security for our obligations to Laurus, we, along with our wholly-owned subsidiary Public Safety Group, Inc. ("PSG"), have granted to Laurus a blanket security interest in all of our assets, and we have entered into a stock pledge with Laurus for the capital stock in PSG. If an event of default occurs under the Senior Convertible Note or the other related investment agreements, 120% of the unpaid principal balance on the Senior Convertible Note, plus accrued interest and fees, shall become immediately due and Laurus shall be entitled to payment of a default interest rate of 1.5% per month on all amounts due under the Senior Convertible Note. Such events of default include the following:

a failure to pay interest and principal payments under the Senior Convertible Note within three days of when due;

a breach by us of any material covenant or term or condition of the Senior Convertible Note or in any of the investment agreements, if not cured within 30 days of such breach;

a breach by us of any material representation or warranty made in the Senior Convertible Note or in any of the investment agreements;



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if we make an assignment for the benefit of our creditors, or a receiver or trustee is appointed for us, or any form of bankruptcy or insolvency proceeding is instituted by us, or any involuntary proceeding is instituted against us if not vacated within 60 days;

the filing of any money judgment or similar final process against us for more than \$50,000, which remains unvacated, unbonded or unstayed for a period of 30 days;

if our common stock is suspended for five consecutive days or for five days during any ten consecutive days from a principal market or pursuant to a Securities and Exchange Commission stop order; and

a failure by us to timely deliver shares of common stock when due upon conversions of the Senior Convertible Note.

Upon an event of default, Laurus will be entitled to specified remedies, including remedies under the Uniform Commercial Code.

We have agreed to register with the Securities and Exchange Commission for resale the shares of common stock that are issuable upon conversion of the Senior Convertible Note and upon exercise of the Senior Warrant. Under the registration rights agreement, we are obligated to file a registration statement with the Securities and Exchange Commission on or before July 8, 2005, and to use reasonable commercial efforts to have the registration statement declared effective not later than September 6, 2005. The resale registration statement was initially filed with the Securities and Exchange Commission on July 8, 2005 for the shares underlying the Senior Convertible Note and Senior Warrant. If we fail to comply with our registration obligations, Laurus will be entitled to certain specified remedies, including monetary liquidated damages. In particular, for each 30 days (or such pro rated number of days) that we are out of compliance with our registration obligations, we will be subject to a liquidated damage assessment of 2% of the original principal amount of the Senior Convertible Note.

Laurus has agreed, pursuant to the Senior Purchase Agreement, that neither it nor any of its affiliates and investment partners will (and will not cause any other person or entity, directly or indirectly, to) engage in "short sales" of our common stock for as long as any Senior Convertible Note held by it remain outstanding. "Short sales" are contracts for the sale of shares of stock that the seller does not own, or certificates which are not within the seller's control, so as to be available for delivery at the time when, under applicable rules, delivery must be made.

The Company entered into an Amendment and Waiver with Laurus, dated as of August 31, 2005, pursuant to which the Company was permitted to defer the payment of the monthly principal amounts due and payable for the months of September, October, November and December 2005 under both (a) the Secured Convertible Term Note in the original principal amount of \$5,000,000 issued by the Company to Laurus on September 29, 2004 (the "September 2004 Note"), and (b) the Secured Convertible Term Note, such aggregate deferred principal amounts being equal to \$625,000 and \$187,500, respectively. The deferred principal amount under the September 2004 Note is now due on September 29, 2007, the maturity date of that note, and will be paid at the same time the final payments due with respect to that note upon maturity. The deferred principal amount under the Senior Convertible Note is now due on June 7, 2008, the maturity date of that note, and will be paid at the same time the final payments due with respect to that note upon maturity. The Company will remain obligated to pay all monthly interest amounts under these notes as they are currently due.

Pursuant to this Amendment and Waiver, the Company issued an aggregate of 612,166 shares of its Common Stock to Laurus as consideration for this principal payment deferral. The Company entered into a Registration Rights Agreement dated as of August 31, 2005 (the "Registration Rights Agreement") pursuant to which the Company has agreed to file a registration statement with the Securities and Exchange Commission (the "SEC") covering the resale of these shares of Common

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Stock. The resale registration statement was initially filed with the SEC on September 11, 2006, and became effective on December 19, 2006.

Effective as of January 23, 2006, the Company entered into an Amendment and Waiver with Laurus in connection with all Secured Convertible Notes then held by Laurus. Under that Secured Notes Amendment and Waiver, the 2004 Senior Note and the 2005 Senior Note were amended as follows: (i) the maturity date of the 2004 Senior Note was extended to January 1, 2008; (ii) the maturity date of the 2005 Senior Note was extended to December 1, 2008, and (iii) the fixed conversion price under each of these Secured Notes was reset from \$1.35 to \$0.85 per share. In addition, the exercise price of all warrants to purchase Common Stock of the Company held by Laurus was reset to \$1.00 per share. Pursuant to this Amendment and Waiver, the Company issued an aggregate of 150,000 shares of its Common Stock to Laurus as consideration for this principal payment deferral. The Company entered into a Registration Rights Agreement dated as of January 23, 2006 pursuant to which the Company has agreed to file a registration statement with the SEC covering the resale of these shares of Common Stock. The resale registration statement was initially filed with the SEC on September 11, 2006, and became effective on December 19, 2006.

Effective as of August 10, 2006, the Company also entered into an Amendment and Waiver with Laurus in connection with the holder of its Secured Convertible Notes currently held by Laurus. Under the Amendment and Waiver, the September 2004 Note and June 2005 Note were amended as follows: (i) the principal amounts due and payable under the 2004 Note and the 2005 Note for the months of August and September 2006, respectively, shall be paid in shares of the Company's Common Stock priced at \$0.50 per share; and (ii) the principal amount due and payable under the 2004 Note for the months of October, November and December 2006 is deferred until January 1, 2008, the final maturity date of the 2004 Note, and the principal amount due and payable under the 2005 Note for the months of October, November and December 2006 is deferred until December 1, 2008, the final maturity date of the 2005 Note. Pursuant to this Amendment and Waiver, the Company issued 150,000 shares of its common stock to Laurus as consideration for the principal payment deferral. In connection with this financing, the Company also reduced the conversion price of the Series A and Series B Convertible Preferred shares"font-size:1px"> **14,623** 17,168

Net deferred tax asset/(liability)

**\$8,903** \$(1,041)

Deferred tax assets (liabilities) are reflected on the Company's Consolidated Balance Sheets as follows:

	February 2, 2008	February 3, 2007
Current deferred tax assets (included in prepaid expenses and other current assets)	\$ 405	
Current deferred tax liabilities (included in accrued liabilities)		\$ (501)
Non-current deferred tax assets (included in other assets)	8,498	
Non-current deferred tax liabilities (included in other liabilities)		(540)
<b>Net deferred tax asset (liability)</b>	<b>\$ 8,903</b>	<b>\$ (1,041)</b>

The components of income tax benefit (provision) are as follows:

	2007	2006	2005
<b>Current:</b>			
Federal	\$ (1,149)	\$ (24,438)	\$ (29,333)
State	(346)	(1,852)	(2,502)
	<b>(1,495)</b>	<b>(26,290)</b>	<b>(31,835)</b>
<b>Deferred:</b>			
Federal	3,738	4,234	1,962
State	401	302	152
	<b>4,139</b>	<b>4,536</b>	<b>2,114</b>

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Tax expense recognized for FIN 48 uncertainties	(444)		
Interest and penalties, gross of related tax effects	(150)		
Income tax benefit (provision)	\$ 2,050	\$ (21,754)	\$ (29,721)

In addition to the increase from the deferred tax benefit, the net deferred tax asset increased \$5.8 million in 2007 due to the recording of deferred taxes assets related to the adoption of FIN48.

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**Table of Contents****STEIN MART, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in tables in thousands, except per share amounts)

During 2007, 2006 and 2005, the Company realized tax benefits of \$0.2 million, \$0.8 million and \$4.6 million, respectively, related to share-based compensation plans that were credited to additional paid-in-capital. The income tax benefit (provision) differs from the amount of income tax determined by applying the statutory U.S. corporate tax rate to pre-tax amounts due to the following items:

	2007	2006	2005
Federal tax at the statutory rate	35.0%	(35.0)%	(35.0)%
State income taxes, net of federal benefit	6.1	(4.1)	(3.3)
Business tax credits	3.5	1.3	0.4
Effect of FIN48	(9.0)		
Compensation-related items	(2.7)	(0.2)	(0.1)
Other permanent items	(1.7)	1.1	1.1
<b>Income tax benefit (provision)</b>	<b>31.2%</b>	<b>(36.9)%</b>	<b>(36.9)%</b>

The Company adopted the provisions of FIN48 on February 4, 2007. As a result of the implementation of FIN 48, the Company recognized a \$0.2 million increase in the liability for unrecognized tax benefits, which was accounted for as a reduction of retained earnings. The following is a reconciliation of the change in the amount of unrecognized tax benefits from February 4, 2007 to February 2, 2008:

Balance at February 4, 2007	\$ 7,267
Increases due to:	
Tax positions taken in prior years	3,984
Tax positions taken in current year	375
Decreases due to:	
Tax positions taken in prior years	(3,653)
Settlements with taxing authorities	(6,717)
<b>Balance at February 2, 2008</b>	<b>\$ 1,256</b>

As of February 2, 2008, the total amount of unrecognized tax benefits was \$1.3 million and the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$2.1 million.

The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. The total amount of accrued interest and accrued penalties as of February 2, 2008 was \$0.5 million.

The Company and/or its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company is no longer subject to U.S. federal income tax examinations by tax authorities for fiscal years ended before 2005 and is no longer subject to state and local tax examinations for fiscal years ended before 2003. During 2007, the Internal Revenue Service (IRS) completed its examination of the Company's federal income tax returns for fiscal years 2003 and 2004 and the Company settled with the IRS. The most significant adjustments were related to the Company's revenue recognition associated with gift and return cards. The IRS is currently examining the Company's federal income tax returns for fiscal years 2005 and 2006. This examination is expected to be completed during 2008. It is reasonably possible that an increase in the unrecognized tax benefits may occur as the 2005 temporary differences related to favorable roll forward adjustments from the 2003 and 2004 IRS examination are agreed to; however, we cannot estimate a range at this time.

## 7. Employee Benefit Plans

The Company has a defined contribution retirement plan (a 401K plan) covering employees who are at least 21 years of age, have completed at least one year of service and who work at least 1,000 hours annually. Under the profit sharing portion of the plan, the Company can make discretionary contributions which vest at a rate of 20 percent per year after two years of service. The Company matches 50 percent of an employee's voluntary pre-tax contributions up to a maximum of four percent of an employee's compensation. The Company's matching portion vests in accordance with the plan's vesting schedule. Total Company contributions to the retirement plan, net of forfeitures, were \$1,549,000, \$1,391,000 and \$816,000 for 2007, 2006 and 2005, respectively.

The Company has an executive split dollar life insurance plan wherein eligible executives are provided with pre-retirement life insurance protection based upon three to five times base salary. Upon retirement, the executive is provided with life insurance protection based upon one and one-half to two and one-half times final base salary. The expense for this plan was \$287,000, \$158,000 and \$57,000 in 2007, 2006 and 2005, respectively.

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(Dollars in tables in thousands, except per share amounts)

The Company also has an executive deferral plan providing officers, key executives and director-level employees with the opportunity to participate in an unfunded, deferred compensation program. Under the program, participants may defer up to 100% of their base compensation and bonuses earned. The Company will match the officers and key executives contributions 100%, and the director-level employees contributions 50%, up to the first 10% of compensation deferred. A participant's Company matching contributions and related investment earnings are 20% vested after four years of participation in the plan and increase 20% per year through the eighth year, at which time a participant is fully vested. The liability to the employees for amounts deferred was \$9,824,000 at February 2, 2008 and \$8,921,000 at February 3, 2007, and is included in other liabilities in the Consolidated Balance Sheets. The expense for this plan, net of forfeitures, was \$834,000, \$752,000 and \$831,000 in 2007, 2006 and 2005, respectively.

In connection with the above two plans, whole life insurance contracts were purchased on the related participants. At February 2, 2008 and February 3, 2007, the cash surrender value of these policies was \$15,844,000 and \$13,833,000, respectively, and is included in other assets in the Consolidated Balance Sheets.

**8. Stockholders' Equity*****Stock Repurchase Plan***

During 2007, 2006 and 2005, the Company repurchased 2,438,854 shares, 410,812 shares and 836,550 shares of its common stock in the open market at a total cost of \$26.9 million, \$6.1 million and \$17.3 million, respectively. As of February 2, 2008, there are 807,984 shares which can be repurchased pursuant to the Board of Directors' current authorization.

***Share-Based Compensation Expense***

For the years ended February 2, 2008 and February 3, 2007, pre-tax share-based compensation expense was recorded as follows:

	2007	2006
Cost of merchandise sold	\$ 3,777	\$ 3,432
Selling, general and administrative expenses	2,139	2,073
<b>Total share-based compensation expense</b>	<b>\$ 5,916</b>	<b>\$ 5,505</b>

Included in 2007 share-based compensation expense is \$0.4 million for dividends paid on restricted stock awards that are not expected to vest. As required by SFAS 123R, such payments are recorded as share-based compensation expense instead of dividends paid.

***Share-Based Compensation Plans***

The Company has an Employee Stock Purchase Plan (the "Stock Purchase Plan") whereby all employees who complete six months employment with the Company and who work on a full-time basis or are regularly scheduled to work more than 20 hours per week are eligible to participate in the Stock Purchase Plan. Participants in the Stock Purchase Plan are permitted to use their payroll deductions to acquire shares at 85% of the lower of the fair market value of the Company's stock determined at either the beginning or the end of each option period. In 2007, 2006 and 2005, the participants acquired 190,663 shares, 97,480 shares and 74,120 shares of the Company's common stock at weighted-average per share prices of \$5.91, \$11.90 and \$15.00, respectively. The fair value of Employee Stock Purchase Plan shares was estimated using the Black-Scholes call option value method with the following weighted-average assumptions for 2007: expected volatility of 42.2%, expected dividend yield of 1.9%, a risk-free interest rate of 5.0%, a present-value discount factor of 1.0% and an expected term of six months. Share-based compensation expense for the Stock Purchase Plan was \$0.6 million and \$0.4 million in 2007 and 2006, respectively.

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The Company's Omnibus Plan provides that shares of common stock may be granted to certain key employees and outside directors through non-qualified stock options, incentive stock options, stock appreciation rights, performance awards, restricted stock, or any other award made under the terms of the plan. The Board of Directors, or its delegated authority, determines the exercise price and all other terms of all grants. In general, one-third of the awards granted become exercisable on the third, fourth and fifth anniversary dates of grant and expire seven years after the date of grant.

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(Dollars in tables in thousands, except per share amounts)

The following table presents the number of awards initially authorized and available to grant under the Omnibus Plan (shares in thousands):

	<b>Shares</b>
Awards initially authorized	4,500
Shares registered December 2007	3,000
<b>Total awards authorized</b>	<b>7,500</b>
Awards available for grant:	
January 28, 2006	2,495
February 3, 2007	1,233
February 2, 2008	4,147

**Stock Options**

The fair value of each stock option granted during 2007 and 2006 was estimated at the date of grant using the Black-Scholes options pricing model with the following weighted-average assumptions: expected volatility of 46.2% and 47.2% respectively, expected dividend yield of 2.1% and 1.5% respectively, a risk-free interest rate of 4.4% and 4.8% respectively, and an expected option term of 4.8 years and 5.2 years respectively. The expected volatility is based on the historical volatility of our stock prices over assumed expected terms. The risk-free interest rate is estimated from yields of U.S. Treasury instruments of varying maturities with terms consistent with the expected terms of the options. The expected term of an option is calculated from a lattice model using historical employee exercise data.

A summary of stock option information for the three years ended February 2, 2008 is as follows (in thousands, except per share amounts):

	<b>Number of Shares</b>	<b>Weighted-Average Exercise Price</b>	<b>Aggregate Intrinsic Value</b>	<b>Weighted-Average Remaining Contractual Term</b>
Outstanding at January 29, 2005	3,642	\$ 11.55		
Granted	445	20.83		
Exercised	(1,214)	12.46		
Cancelled or forfeited	(98)	11.82		
Outstanding at January 28, 2006	2,775	12.63		
Granted	751	16.66		
Exercised	(190)	11.23		
Cancelled or forfeited	(72)	13.82		
Outstanding at February 3, 2007	3,264	13.81		
Granted	567	12.35		
Exercised	(284)	12.39		
Cancelled or forfeited	(914)	15.76		
<b>Outstanding at February 2, 2008</b>	<b>2,633</b>	<b>\$ 12.75</b>	<b>\$ 37</b>	<b>3.9 years</b>



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<b>Exercisable stock options at February 2, 2008</b>	<b>1,475</b>	<b>\$</b>	<b>9.81</b>	<b>\$</b>	<b>21</b>	<b>2.9 years</b>
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The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading date of 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on February 2, 2008. This amount changes based on the fair market value of the Company's common stock.

As of February 2, 2008, there was \$3.9 million of unrecognized compensation cost related to stock options which is expected to be recognized over a weighted-average period of 2.4 years. The weighted-average grant-date fair value of options granted during 2007 was \$4.91. The total intrinsic value of stock options exercised during 2007, 2006 and 2005 was approximately \$0.9 million, \$0.9 million and \$12.1 million, respectively. Cash received and the total tax benefit from the exercise of stock options during 2007 was \$3.5 million and \$0.3 million, respectively.

On August 27, 2007 the Company's Board of Directors appointed Linda M. Farthing as President and Chief Executive Officer of the Company. Ms. Farthing was granted an option to purchase 200,000 shares of the Company's common stock, at an exercise price of \$8.56, under the Company's 2001 Omnibus Plan. The options, valued at \$527,000, vested immediately and were recognized as expense

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during the third quarter of 2007. The options may not be exercised after the earlier of seven years from August 27, 2007 or 90 days following Ms. Farthing's ceasing to be either an executive officer or a member of the Board of Directors of the Company. Shares acquired on exercise of the options may not be sold until the earlier of August 27, 2008 or a change of control of the Company.

***Restricted Stock and Performance Share Awards***

The Company has issued restricted stock awards to eligible key employees and directors. All restricted stock awards have restriction periods tied primarily to employment, and all performance share awards have vesting tied to service and performance. Shares awarded under the plan entitle the shareholder to all rights of common stock ownership except that the shares may not be sold, transferred, pledged, exchanged or otherwise disposed of during the restriction period. For most awards, vesting is based on the service period and vesting occurs (1) 100% at the end of seven years following the date of grant, (2) at the rate of 33%, 33% and 34%, respectively, at the end of each of the first three years, (3) 100% at the end of the third year, or (4) at the rate of 33%, 33% and 34%, respectively, at the end of the third, fourth and fifth years. For awards that fully vest at the end of seven years following the date of grant, vesting is accelerated to the end of the second fiscal year if certain defined Company performance goals are achieved. Unvested shares are forfeited upon termination of employment. The total value of share-based compensation expense for restricted stock is based on the closing price of the Company's stock on the date of grant.

The Company's Management Incentive Compensation Plan (the "Compensation Plan"), as amended in June 2006, provides for long-term incentive compensation, payable as performance shares (60%) and stock options (40%) to certain qualified key employees. Long-term incentive compensation will be awarded only if EPS goals are met, and aggregate compensation value is based on each key employee's position. These performance shares ("EPS Performance Shares") are earned based on aggregate EPS goals for a three year rolling period and options are granted based on annual EPS goals. As defined by the Compensation Plan, 50% of the performance shares will be earned if the aggregate three year actual EPS equals Threshold (85% of goal), 100% of the performance shares will be earned if the aggregate three year actual EPS equals Target (100% of goal), and 150% of the performance shares will be earned if the aggregate three year actual EPS equals Superior (115% of goal). The number of stock options to be granted is based on a calculation of option values as defined in the Compensation Plan.

In accordance with SFAS No. 123R, recording of share-based compensation expense for awards with performance conditions is based on the probable outcome of that performance condition. EPS Performance Shares are earned based on the Company's achieving aggregate three year EPS goals. Due to the effect of the 2006 and 2007 EPS shortfall to goal, no share-based compensation expense was recorded for these performance-based shares in 2006 or 2007.

During fiscal 2006, 240,000 performance shares were granted to certain key employees as provided by the Omnibus Plan. A total of 115,000 performance shares become fully vested when the NASDAQ market price ("MP") for the Company's stock equals or exceeds \$18.00 per share for twenty consecutive trading days before the fourth anniversary of the grant date. The remaining 125,000 performance shares vest in the same manner when the MP equals or exceeds \$24.00 per share. The total value of share-based compensation expense for these market condition awards, referred to herein as "MP Performance Shares", was determined by multiplying the total number of shares expected to be issued by the performance share fair value and is being recognized over the weighted-average implicit performance period. Since the MP Performance Shares contain a market condition for vesting, the fair value of the awards was determined using a Monte Carlo simulation model with the following assumptions: expected volatility of 45.3%, expected dividend yield of 1.7%, a four-year expected return of 21.7% and a contractual term of four years. The expected volatility is based on the historical volatility of our stock prices over assumed expected terms.

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(Dollars in tables in thousands, except per share amounts)

A summary of restricted stock awards and MP Performance Share activity as of and for the three years ended February 2, 2008 is as follows (shares in thousands):

	Restricted Stock Awards		MP Performance Shares	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Non-vested at January 29, 2005	85	\$ 8.86		
Granted	192	21.33		
Vested	(6)	13.45		
Forfeited	(9)	13.25		
Non-vested at January 28, 2006	262	17.75		
Granted	361	14.31	240	\$ 14.24
Vested	(57)	6.36		
Forfeited	(22)	19.78		
Non-vested at February 3, 2007	544	16.82	240	14.24
Granted	178	9.12		
Vested	(19)	16.36		
Forfeited	(123)	20.51		
<b>Non-vested at February 2, 2008</b>	<b>580</b>	<b>\$ 14.39</b>	<b>240</b>	<b>\$ 14.24</b>

Total unrecognized compensation cost	\$ 5,548	\$ 158
Weighted-average expected life remaining	3.4 years	49 days

The total fair value of restricted stock awards vested during fiscal 2007 was \$0.2 million. As of February 2, 2008, there were no vested MP Performance Shares.

**Prior Period Pro Forma Presentation**

Prior to January 29, 2006, the Company accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion ( APB ) No. 25 and related interpretations. The Company also followed the disclosure requirements of SFAS No. 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. The following table illustrates the pro forma effect on net income and earnings per share for 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to share-based employee awards prior to January 29, 2006:

Net income as reported	\$ 50,884
Add: Share-based compensation expense included in net income, net of related tax effects	555
Less: Share-based compensation expense determined under the fair value method, net of related tax effects	(1,743)

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Pro forma net income	\$ 49,696
Basic earnings per share as reported	\$ 1.18
Basic earnings per share pro forma	\$ 1.15
Diluted earnings per share as reported	\$ 1.15
Diluted earnings per share pro forma	\$ 1.12

The fair value of options granted during 2005 was estimated on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for grants made during 2005: expected volatility of 50.9%, expected dividend yield of 0.0%, a risk-free interest rate of 4.0% and expected option term of five years. An expected dividend yield of 0.0% was used because the Company did not pay dividends prior to May 2005. The weighted-average fair value of options granted during 2005 was \$11.

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**9. Store Closing Charges**

The Company closes under-performing stores in the normal course of business. The Company closed two stores during 2007, six stores during 2006 and six stores during 2005 incurring pre-tax lease termination and severance costs of \$0.6 million, \$1.1 million and \$1.1 million, respectively. Lease termination costs are net of estimated sublease income that could reasonably be obtained for the properties. In the event the Company is not successful in subleasing closed store locations when management expects, additional reserves for store closing costs may be recorded. During 2007, 2006 and 2005, the Company recorded net pre-tax charges of \$0.5 million, \$0.7 million and \$1.6 million, respectively, to adjust previously recorded store closing reserves for changes in estimated sublease income, net of a lease termination recovery. Store closing charges are included in SG&A expenses in the Consolidated Statements of Operations.

The following tables show the activity in the store closing reserve:

	February 3, 2007	Charges	Payments	February 2, 2008
Lease termination costs	\$ 4,639	\$ 889	\$ 2,207	\$ 3,321
Severance		256	256	
<b>Total store closing reserve</b>	<b>\$ 4,639</b>	<b>\$ 1,145</b>	<b>\$ 2,463</b>	<b>\$ 3,321</b>

	January 28, 2006	Charges	Payments	February 3, 2007
Lease termination costs	\$ 5,522	\$ 1,325	\$ 2,208	\$ 4,639
Severance	63	452	515	
<b>Total store closing reserve</b>	<b>\$ 5,585</b>	<b>\$ 1,777</b>	<b>\$ 2,723</b>	<b>\$ 4,639</b>

	January 29, 2005	Charges	Payments	January 28, 2006
Lease termination costs	\$ 6,898	\$ 2,164	\$ 3,540	\$ 5,522
Severance	131	534	602	63
<b>Total store closing reserve</b>	<b>\$ 7,029</b>	<b>\$ 2,698</b>	<b>\$ 4,142</b>	<b>\$ 5,585</b>

The store closing reserve at February 2, 2008, February 3, 2007 and January 28, 2006 includes a current portion (in accrued liabilities) of \$1.2 million, \$2.1 million and \$2.8 million, respectively, and a long-term portion (in other liabilities) of \$2.1 million, \$2.5 million and \$2.8 million, respectively.

**10. Sales by Major Merchandise Category**

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The Company is a single business segment as defined by SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. SFAS No. 131 requires that companies report revenues for each product or group of similar products. The following table summarizes the Company's sales by major merchandise category:

	2007	2006	2005
Ladies' apparel and accessories	\$ 901,719	\$ 901,289	\$ 878,934
Men's apparel and accessories	309,832	316,408	298,809
Gifts and linens	203,683	226,272	231,382
Other	42,411	57,327	72,490
<b>Net sales</b>	<b>\$ 1,457,645</b>	<b>\$ 1,501,296</b>	<b>\$ 1,481,615</b>

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**11. Quarterly Results of Operations (Unaudited)**

	<b>13 Weeks Ended</b>	<b>13 Weeks Ended</b>	<b>13 Weeks Ended</b>	<b>13 Weeks Ended</b>
<b>Year Ended February 2, 2008</b>	<b>May 5, 2007</b>	<b>Aug. 4, 2007</b>	<b>Nov. 3, 2007</b>	<b>Feb. 2, 2008</b>
Net sales	\$ 376,119	\$ 330,739	\$ 333,343	\$ 417,444
Gross profit	104,910	86,198	86,212	84,090
Net income (loss)	8,112	2,195	(2,689)	(12,148)
Basic income (loss) per share	\$ 0.19	\$ 0.05	\$ (0.06)	\$ (0.30)
Diluted income (loss) per share	\$ 0.18	\$ 0.05	\$ (0.06)	\$ (0.30)

	<b>13 Weeks</b>	<b>13 Weeks</b>	<b>13 Weeks</b>	<b>14 Weeks</b>
<b>Year Ended February 3, 2007</b>	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>
	<b>Apr. 29, 2006</b>	<b>July 29, 2006</b>	<b>Oct. 28, 2006</b>	<b>Feb. 3, 2007</b>
Net sales	\$ 364,831	\$ 336,304	\$ 339,171	\$ 460,990
Gross profit	97,586	94,006	89,262	135,467
Net income	7,559	8,312	237	21,068
Basic income per share	\$ 0.17	\$ 0.19	\$ 0.01	\$ 0.49
Diluted income per share	\$ 0.17	\$ 0.19	\$ 0.01	\$ 0.48

**12. Legal Proceedings**

The Company is involved in various routine legal proceedings incidental to the conduct of its business. Management, based upon the advice of outside legal counsel, does not believe that any of these legal proceedings will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

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**EXHIBIT INDEX**

- 3.1 Articles of Incorporation of Stein Mart, Inc., incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 3.2 Bylaws of Stein Mart, Inc., amended September 8, 2003, incorporated by reference to the Company's Form 10-K for the fiscal year ended January 31, 2004
- 4.1 Provisions of the Articles of Incorporation and Bylaws of Stein Mart, Inc. defining rights of shareholders of Common Stock of Stein Mart, Inc., incorporated by reference to the Company's Form 10-K for the fiscal year ended December 30, 2000
- 4.2 Form of stock certificate for Common Stock, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.1\* Form of Director's and Officer's Indemnification Agreement, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.2\* Form of Non-Qualified Stock Option Agreement, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.3\* Form of Incentive Stock Option Agreement, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.4\* Form of Option Award Agreement for Key Employees, pursuant to Stein Mart, Inc. 2001 Omnibus Plan, incorporated by reference to the Company's Form S-8 Registration Statement filed on August 7, 2001
- 10.5 Form of Option Award Agreement for Non-Employee Directors, pursuant to Stein Mart, Inc. 2001 Omnibus Plan, incorporated by reference to the Company's Form S-8 Registration Statement filed on August 7, 2001
- 10.6\* Form of Restricted Share Award Agreement for Key Employees, pursuant to Stein Mart, Inc. 2001 Omnibus Plan, incorporated by reference to the Company's Form 10-K for the fiscal year ended January 31, 2004
- 10.7\* Form of Performance Share Award Agreement for Key Employees, pursuant to Stein Mart, Inc. 2001 Omnibus Plan, incorporated by reference to the Company's Form 10-Q for the quarterly period ended October 28, 2006
- 10.8 Profit Sharing Plan, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.9\* Executive Health Plan, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.10\* Director Stock Option Plan, incorporated by reference to the Company's Form S-1 Registration Statement No. 33-46322
- 10.11\* Executive Split Dollar Plan, incorporated by reference to the Company's Form 10-K for the fiscal year ended January 1, 2000
- 10.12 Stein Mart, Inc. 2001 Omnibus Plan, incorporated by reference to the Company's Form S-8 Registration Statement filed on August 7, 2001
- 10.13 First Amendment to Stein Mart, Inc. 2001 Omnibus Plan, dated December 12, 2006, incorporated by reference to the Company's Form 10-K for the fiscal year ended February 3, 2007
- 10.14\* Executive Deferral Plan, amended November 1, 2002, incorporated by reference to the Company's Form 10-K for the fiscal year ended January 31, 2004



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- 10.15\* Management Incentive Compensation Plan, amended June 6, 2006, incorporated by reference to the Company's Form 10-Q for the quarterly period ended July 29, 2006
- 10.16\* Employment Agreement, dated as of July 11, 2005, between Stein Mart, Inc. and Michael D. Fisher, incorporated by reference to the Company's Form 8-K filed on July 15, 2005
- 10.17\* Separation Agreement and Release, dated as of August 27, 2007, between Stein Mart, Inc. and Michael D. Fisher, incorporated by reference to the Company's Form 8-K/A filed on October 5, 2007
- 10.18\* Employment Agreement, dated as of July 11, 2005, between Stein Mart, Inc. and James G. Delfs, incorporated by reference to the Company's Form 8-K filed on July 15, 2005
- 10.19\* Employment Agreement, dated as of September 16, 2006, between Stein Mart, Inc. and D. Hunt Hawkins, incorporated by reference to the Company's Form 8-K filed on September 25, 2006
- 10.20\* Employment Agreement, dated as of July 11, 2005, between Stein Mart, Inc. and Michael D. Ray, incorporated by reference to the Company's Form 8-K filed on July 15, 2005
- 10.21\* Employment Agreement, dated as of September 16, 2006, between Stein Mart, Inc. and William A. Moll, incorporated by reference to the Company's Form 8-K filed on September 25, 2006
- 10.22\* Employment Agreement, dated as of August 27, 2007, between Stein Mart, Inc. and Linda McFarland Farthing, incorporated by reference to the Company's Form 8-K/A filed on October 5, 2007
- 10.23\* Option Award Agreement, pursuant to Stein Mart, Inc. 2001 Omnibus Plan, dated August 27, 2007, between Stein Mart, Inc. and Linda McFarland Farthing, incorporated by reference to the Company's Form 8-K filed on August 31, 2007
- 10.24 Loan and Security Agreement dated July 18, 2003, among Stein Mart, Inc., Wachovia Bank, National Association and Fleet Retail Finance, Inc. as Co-Arrangers, Congress Financial Corporation (Florida) as Administrative and Collateral Agent, General Electric Capital Corporation as Documentation Agent and the Lenders (as such terms are defined in the Credit Agreement), incorporated by reference to the Company's Form 10-Q for the quarter ended August 2, 2003
- 10.25 Amendment No. 1 to Loan and Security Agreement dated January 11, 2006 between Stein Mart, Inc. and Wachovia Bank, National Association (successor to Congress Financial Corporation), incorporated by reference to the Company's Form 8-K filed on January 17, 2006
- 10.26 Amended and Restated Supply Agreement, dated May 30, 2006, between DSW, Inc. and Stein Mart, Inc., incorporated by reference to the Company's Form 8-K filed on June 5, 2006
- 10.27 Co-Brand Credit Card Consumer Program Agreement by and between Stein Mart, Inc. and GE Money Bank, dated as of September 28, 2006, incorporated by reference to the Company's Form 8-K filed on October 4, 2006
- 23.1 Consent of PricewaterhouseCoopers LLP (filed herein)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002 (filed herein)
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002 (filed herein)
- 32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 (filed herein)
- 32.2 Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 (filed herein)

\* Management contract or compensatory plan or arrangements.