

BIO KEY INTERNATIONAL INC

Form 10-Q

November 14, 2017

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2017

or

TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE EXCHANGE ACT

For the Transition Period from            to

Commission file number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation of organization)

41-1741861

(IRS Employer Identification Number)

3349 HIGHWAY 138, BUILDING A, SUITE E, WALL, NJ 07719

(Address of principal executive offices)

(732) 359-1100

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Number of shares of Common Stock, \$.0001 par value per share, outstanding as of November 13, 2017 was 7,691,324.

**BIO-KEY INTERNATIONAL, INC.**

**INDEX**

**PART I. FINANCIAL INFORMATION**

Item 1	Financial Statements	
	Condensed and consolidated balance sheets as of September 30, 2017 (unaudited) and December 31, 2016	3
	Condensed and consolidated statements of operations for the three and nine months ended September 30, 2017 and 2016 (unaudited)	4
	Condensed and consolidated statements of cash flows for the nine months ended September 30, 2017 and 2016 (unaudited)	5
	Notes to condensed consolidated financial statements	7
Item 2	Management's Discussion and Analysis of Financial Conditions and Results of Operations	19
Item 4	Controls and Procedures	27

**PART II. OTHER INFORMATION**

Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	28
Item 6	Exhibits	28
	Signatures	29

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**PART I -- FINANCIAL INFORMATION****BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>September 30,</b>	<b>December 31,</b>
	<b>2017</b>	<b>2016</b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
Cash and cash equivalents	\$971,857	\$1,061,307
Accounts receivable, net	562,296	1,563,246
Due from factor	28,750	53,638
Inventory	879,592	465,428
Software license rights	2,370,000	1,560,000
Prepaid expenses and other	175,955	206,677
Total current assets	4,988,450	4,910,296
Software license rights, net of current portion	8,590,368	10,598,411
Accounts receivable, net of current portion	1,070,000	1,570,000
Equipment and leasehold improvements, net	186,917	67,814
Deposits and other assets	8,712	8,712
Intangible assets, net	175,896	134,132
Total non-current assets	10,031,893	12,379,069
<b>TOTAL ASSETS</b>	<b>\$15,020,343</b>	<b>\$17,289,365</b>
<b>LIABILITIES</b>		
Accounts payable	\$507,886	\$466,842
Accrued liabilities	427,671	335,323
Dividends payable on preferred stock	463,125	401,250
Deferred revenue	308,622	633,062
Total current liabilities	1,707,304	1,836,477
<b>TOTAL LIABILITIES</b>	<b>1,707,304</b>	<b>1,836,477</b>

Commitments and contingencies

**STOCKHOLDERS' EQUITY:**

Series A-1 convertible preferred stock; authorized, 100,000 (liquidation preference of \$100 per share): issued and outstanding 90,000 of \$.0001 par value at September 30, 2017 and December 31, 2016, respectively	9	9
Series B-1 convertible preferred stock; authorized, 105,000 (liquidation preference of \$100 per share): issued and outstanding 105,000 of \$.0001 par value at September 30, 2017 and December 31, 2016, respectively	11	11

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Common stock — authorized, 170,000,000 shares; \$.0001 par value issued and outstanding; 6,927,826 and 6,093,843 at September 30, 2017 and December 31, 2016, respectively	692	609
Additional paid-in capital	80,864,782	78,253,413
Accumulated deficit	(67,552,455)	(62,801,154)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>13,313,039</b>	<b>15,452,888</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 15,020,343</b>	<b>\$ 17,289,365</b>

All BIO-key shares issued and outstanding for all periods reflect BIO-key's 1-for-12 reverse stock split, which was effective December 29, 2016.

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.

**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30, 2017</b>	<b>2016</b>	<b>September 30, 2017</b>	<b>2016</b>
Revenues				
Services	\$377,113	\$187,025	\$831,761	\$692,677
License fees and other	53,023	25,435	677,342	142,651
Hardware	512,281	219,003	1,738,530	442,541
Total Revenues	942,417	431,463	3,247,633	1,277,869
Costs and other expenses				
Cost of services	190,889	46,257	285,369	168,636
Cost of license fees, hardware and other	732,192	125,526	2,094,608	251,485
Total costs and other expenses	923,081	171,783	2,379,977	420,121
Gross Profit	19,336	259,680	867,656	857,748
Operating Expenses				
Selling, general and administrative	1,238,296	925,939	4,289,655	2,957,368
Research, development and engineering	386,830	528,554	1,329,322	1,584,403
	1,625,126	1,454,493	5,618,977	4,541,771
Operating loss	(1,605,790)	(1,194,813)	(4,751,321)	(3,684,023)
Other income				
Interest income	6	6	20	19
Gain on derivative liabilities	-	60,385	-	10,879
Total other income	6	60,391	20	10,898
Net loss	(1,605,784)	(1,134,422)	(4,751,301)	(3,673,125)
Convertible preferred stock dividends	(200,625 )	(200,625 )	(601,875 )	(601,875 )
Net loss available to common stockholders	\$(1,806,409)	\$(1,335,047)	\$(5,353,176)	\$(4,275,000)
<b>Basic and Diluted Loss per Common Share</b>	<b>\$(0.28 )</b>	<b>\$(0.24 )</b>	<b>\$(0.85 )</b>	<b>\$(0.77 )</b>
<b>Weighted Average Shares Outstanding:</b>				
Basic and Diluted	6,535,449	5,530,105	6,333,530	5,521,218

All BIO-key shares issued and outstanding for all periods reflect BIO-key's 1-for-12 reverse stock split, which was effective December 29, 2016.

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.

**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	<b>2016</b>
	<b>2017</b>	<b>2016</b>
<b>CASH FLOW FROM OPERATING ACTIVITIES:</b>		
Net loss	\$(4,751,301)	\$(3,673,125)
<b>Adjustments to reconcile net loss to cash used for operating activities:</b>		
Allowance for doubtful accounts	500,000	
Depreciation	33,526	37,764
Amortization of intangible assets	10,280	10,205
Amortization of software license rights	1,118,436	-
Gain on derivative liabilities	-	(10,879 )
Share-based and warrant compensation for employees and consultants	774,968	231,983
Stock based directors fees	28,025	48,999
<b>Change in operating assets and liabilities:</b>		
Accounts receivable	1,000,950	957,024
Due from factor	24,888	33,380
Inventory	(414,164 )	(219,591 )
Prepaid expenses and other	(18,578 )	(39,205 )
Software license rights	79,607	450
Accounts payable	41,044	(607,748 )
Accrued liabilities	92,348	(156,000 )
Deferred revenue	(324,440 )	(136,251 )
Net cash used for operating activities	(1,804,411)	(3,522,994)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(204,673 )	(52,976 )
Net cash used for investing activities	(204,673 )	(52,976 )
<b>CASH FLOW FROM FINANCING ACTIVITIES:</b>		
Issuance of common stock	2,000,000	
Preferred dividends paid	-	(535,100 )
Costs to issue preferred and common stock	(80,366 )	(32,620 )
Net cash provided by (used for) financing activities	1,919,634	(567,720 )
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(89,450 )</b>	<b>(4,143,690)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>1,061,307</b>	<b>4,321,078</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$971,857</b>	<b>\$177,388</b>

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.





**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

**SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2017</b>	<b>2016</b>
<b>Cash paid for:</b>		
Interest	\$-	\$-
<b>Noncash Investing and financing activities</b>		
Issuance of common stock for consultancy services	\$ 114,585	\$-
Conversion of preferred stockholder dividends	\$(540,000)	\$-
Accrual of preferred stockholder dividends	\$601,875	\$200,625

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.

## **BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARIES**

### **NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

September 30, 2017 (Unaudited)

#### **1. NATURE OF BUSINESS AND BASIS OF PRESENTATION**

##### *Nature of Business*

BIO-key International, Inc. was founded in 1993 as a fingerprint biometric technology company. 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. We develop and market advanced fingerprint biometric identification and identity verification technologies, cryptographic authentication-transaction security technologies, as well as related identity management and credentialing software solutions. We sell our products and provide services primarily to commercial entities within highly regulated industries, like healthcare and financial services and the broader corporate enterprise.

##### *Basis of Presentation*

The accompanying unaudited interim condensed consolidated financial statements include the accounts of BIO-key International, Inc. and its wholly-owned subsidiary (collectively, the “Company”, or “BIO-key”) and are stated in conformity with accounting principles generally accepted in the United States of America, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). The operating results for interim periods are not necessarily indicative of results that may be expected for any other interim period or for the full year. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted. Significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company’s financial position and the results of its operations and cash flows for the periods presented. The balance sheet at December 31, 2016 was derived from the audited financial statements, but does not include all of the disclosures

required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016 (the "Form 10-K"), filed with the SEC on March 31, 2017.

*Recently Issued Accounting Pronouncements*

In May 2014, ASU No. 2014-09, "Revenue from Contracts with Customers" was issued. The comprehensive new standard will supersede existing revenue recognition guidance and require revenue to be recognized when promised goods or services are transferred to customers in amounts that reflect the consideration to which the Company expects to be entitled in exchange for those goods or services. The guidance will also require that certain contract costs incurred to obtain or fulfill a contract, such as sales commissions, be capitalized as an asset and amortized as revenue is recognized. Adoption of the new rules could affect the timing of both revenue recognition and the incurrence of contract costs for certain transactions. The guidance permits two implementation approaches, one requiring retrospective application of the new standard with restatement of prior years and one requiring prospective application of the new standard with disclosure of results under old standards. The new standard was scheduled to be effective for reporting periods beginning after December 15, 2016 and early adoption is not permitted. In August 2015, the FASB issued ASU 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of Effective Date" ("ASU 2015-14") which defers the effective date of ASU 2014-09 by one year. ASU 2014-09 is now effective for annual reporting periods beginning after December 15, 2017 including interim periods within that reporting period.

The Company is continuing to evaluate the standard's impact on its consolidated results of operations and financial condition. BIO-key has conducted initial analyses, developed a project management plan relative to the process of adopting this ASU, and is currently completing detailed contract reviews to determine potential adjustments to existing accounting policies as well as to support an evaluation of the standard's impact on the Company's consolidated results of operations and financial condition. For the majority of BIO-key's revenue arrangements, no significant impacts are expected. However, in addition to expanded disclosures regarding revenue, the ASU could, for example, impact the timing of revenue recognition in some arrangements for which software industry-specific guidance (which the ASU supersedes) is presently utilized. The Company currently anticipates utilizing the modified retrospective method of adoption on January 1, 2018.

In July 2015, the FASB issued ASU No. 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory" ("ASU 2015-11"). The amendments in ASU 2015-11 clarifies the measurement of inventory to be the lower of cost or realizable value and would only apply to inventory valued using the FIFO or average costing methods. ASU 2015-11 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The reporting entity should apply the amendments prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The adoption of ASU 2015-11 did not materially impact the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The update addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments, specifically equity investments and financial instruments measured at amortized cost. ASU 2016-01 is effective for public companies for annual and interim periods beginning after December 15, 2017. Management is currently assessing the impact that ASU 2016-01 will have, if any, on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases". The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of its pending adoption of the new standard on its consolidated financial statements, but expects that it will increase its assets and liabilities for amounts yet to be determined.

In August 2014, the FASB issued ASU No. 2014-15, "Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern". Prior to ASU 2014-15, a definition for substantial doubt did not exist. However, the new guidance says that substantial doubt exists when relevant conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are available to be issued. The FASB's definition could be perceived as a higher threshold than current practice as the term "probable" means likely to occur. Under the new standard, management should evaluate all relevant known conditions, or those that can be reasonably expected to happen as of the date the financial statements are to be issued. This evaluation should be both qualitative and quantitative in nature, and should include conditions that might give rise to substantial doubt. ASU 2014-15 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company adopted ASU 2014-15 during the quarter ended March 31, 2017.

In March 2016, the FASB issued Accounting Standards Update 2016-09, "Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). ASU 2016-09 requires, among other things, that excess tax benefits and tax deficiencies be recognized as income tax expense or benefit in the income

statement rather than as additional paid-in capital, changes the classification of excess tax benefits from a financing activity to an operating activity in the statement of cash flows, and allows forfeitures to be accounted for when they occur rather than estimated. ASU 2016-09 is effective for public companies for interim and annual periods beginning after December 15, 2016. The Company will continue to estimate forfeitures at each reporting period, rather than electing an accounting policy change to record the impact of such forfeitures as they occur. The adoption did not have a material impact on the Company's consolidated financial statements.

In July 2017, the FASB issued ASU 2017-11, Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480) and Derivatives and Hedging (Topic 815): I. Accounting for Certain Financial Instruments with Down Round Features; II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Non-controlling Interests with a Scope Exception. Part I of this update addresses the complexity of accounting for certain financial instruments with down round features. Down round features are features of certain equity-linked instruments (or embedded features) that result in the strike price being reduced on the basis of the pricing of future equity offerings. Current accounting guidance creates cost and complexity for entities that issue financial instruments (such as warrants and convertible instruments) with down round features that require fair value measurement of the entire instrument or conversion option. Under ASU 2017-11, down round features do not meet the criteria for derivative accounting and no liability is to be recorded until an actual issuance of securities triggers the down-round feature. Part II of this update addresses the difficulty of navigating Topic 480, Distinguishing Liabilities from Equity, because of the existence of extensive pending content in the FASB Accounting Standards Codification. This pending content is the result of the indefinite deferral of accounting requirements about mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable non-controlling interests. The amendments in Part II of this update do not have an accounting effect. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, with early adoption permitted. The adoption of ASU 2017-11, during the nine months ended September 30, 2017, did not have any impact on the condensed consolidated financial statements, however our disclosures with respect to equity instruments with down round features have been updated. See Note 9 for updated disclosures.

Management does not believe that any other recently issued, but not yet effective, accounting standard if currently adopted would have a material effect on the accompanying consolidated financial statements.

*Reclassification*

Reclassifications occurred to certain prior year amounts in order to conform to the current year classifications. The reclassifications have no effect on the reported net loss.

2. GOING CONCERN

The Company has incurred significant losses to date, and at September 30, 2017, it had an accumulated deficit of approximately \$67.6 million. In addition, broad commercial acceptance of the Company's technology is critical to the Company's success and ability to generate future revenues. At September 30, 2017, total cash and cash equivalents were approximately \$972,000, as compared to approximately \$1,061,000 at December 31, 2016.

The Company has financed itself in the past through access to the capital markets by issuing secured and convertible debt securities, convertible preferred stock, common stock, and through factoring receivables. The Company estimates that it currently requires approximately \$592,000 per month to conduct operations and pay dividend obligations, a monthly amount that it has been unable to achieve consistently through revenue generation.

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

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"), which contemplate continuation of the Company as a going concern, and assumes continuity of operations, realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The matters described in the preceding paragraphs raise substantial doubt about the Company's ability to continue as a going concern. Recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon the Company's ability to meet its financing requirements on a continuing basis, and become profitable in its future operations. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

### 3. ACCOUNTS RECEIVABLE

Accounts receivable are carried at original amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful receivables by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. Accounts receivable are written off when deemed uncollectible. During the year ended December 31, 2016, the Company reclassified a past due receivable to non-current as management concluded that collection may not occur in the near term. As a result of the payment delays, the Company had reserved \$500,000 at December 31, 2016 and in the nine months ended September 30, 2017, the Company reserved an additional \$500,000. The total reserve represents 48% of the remaining balance owed at September 30, 2017. Recoveries of accounts receivable previously written off are recorded when received. Accounts receivable consisted of the following as of:

	<b>September 30, 2017</b>	<b>December 31, 2016</b>
Accounts receivable - current	\$576,081	\$1,577,031
Accounts receivable - non current	2,070,000	2,070,000
	2,646,081	3,647,031
Allowance for doubtful accounts - current	(13,785 )	(13,785 )



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Allowance for doubtful accounts - non current	(1,000,000)	(500,000 )
Accounts receivable, net of allowance for doubtful accounts	\$1,632,296	\$3,133,246

10

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## 4. SHARE BASED COMPENSATION

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

	<b>Three Months Ended September 30, 2017</b>	<b>Three Months Ended September 30, 2016</b>
Selling, general and administrative	\$ 207,047	\$ 31,610
Research, development and engineering	21,663	25,074
	<b>\$ 228,710</b>	<b>\$ 56,684</b>

	<b>Nine Months Ended September 30, 2017</b>	<b>Nine Months Ended September 30, 2016</b>
Selling, general and administrative	\$ 714,167	\$ 221,791
Research, development and engineering	88,826	59,191
	<b>\$ 802,993</b>	<b>\$ 280,982</b>

## 5. FACTORING

Due from factor consisted of the following as of:

	<b>September</b>	<b>December</b>
	<b>30,</b>	<b>31,</b>
	<b>2017</b>	<b>2016</b>

Original invoice value	\$ 115,001	\$ 214,556
Factored amount	(86,251 )	(160,918)
Balance due from factor	\$ 28,750	\$ 53,638

As of December 2011, the Company entered into a 24-month accounts receivable factoring arrangement with a financial institution (the “Factor”). In April 2012, the terms were updated from monthly to quarterly, and the 24-month arrangement was extended to August 1, 2014. In July of 2014, the arrangement was extended to July 31, 2016. In June of 2015, the arrangement was extended to October 31, 2017. Pursuant to the terms of the arrangement, the Company, from time to time, sold to the Factor certain of its accounts receivable balances on a non-recourse basis for credit approved accounts. The Factor remitted 35% of the foreign and 75% of the domestic accounts receivable balance to the Company (the “Advance Amount”), with the remaining balance, less fees, to be forwarded to the Company once the Factor collects the full accounts receivable balance from the customer. In addition, the Company, from time to time, received over advances from the Factor. Factoring fees range from 2.75% to 21% of the face value of the invoice factored, and were determined by the number of days required for collection of the invoice. The cost of factoring was included in selling, general and administrative expenses. The cost of factoring for the three and nine months ended September 30, 2017 and 2016 was as follows:

	<b>Three Months ended</b>		<b>Nine Months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Factoring fees	\$46,409	\$16,264	\$180,126	\$319,627

## 6. INVENTORY

Inventory is stated at the lower of cost, determined on a first in, first out basis, or market, and consists primarily of fabricated assemblies and finished goods. Inventory is comprised of the following as of:

	<b>September 30, 2017</b>	<b>December 31, 2016</b>
Finished goods	\$ 470,544	\$ 381,762
Fabricated assemblies	409,048	83,666
Total inventory	\$ 879,592	\$ 465,428

## 7. RESALABLE SOFTWARE LICENSE RIGHTS

On November 11, 2015, the Company entered into a license agreement for the rights to all software and documentation regarding the technology currently known as or offered under the FingerQ name. The license agreement grants the Company the exclusive right to reproduce, create derivative works and distribute copies of the FingerQ software and documentation, create new FingerQ related products, and grant sub-licenses of the licensed technology to end users. The license rights have been granted to the Company in perpetuity, with a stated number of end-user resale sub-licenses allowed under the contract for a total of \$12,000,000. The cost of sub-license rights expected to be amortized in the following 12 months is \$2,370,000 and is classified as a current asset, and the balance as non-current.

The Company has determined the software license rights to be a finite lived intangible asset, and estimated that the software license rights shall be economically used over a 10 year period, with a weighting towards the beginning years of that time-frame. The license rights were acquired during the fourth quarter of 2015, but the usage of such rights in the Company's products was not generally available until January 2017. Accordingly, amortization began in the first quarter of 2017.

The remaining license rights are to be amortized over the greater of the following: 1) an estimate of the economic use of such license rights, 2) straight line method over ten years, or 3) the actual usage of such rights. The Company believes categorizing the amortization expense under Cost of Sales more closely reflects the nature of the license right arrangement and the use of the technology. During the three month period ended September 30, 2017 the Company sold licenses costing \$1,319 and amortized \$388,681. During the nine month period ended September 30, 2017 the Company sold licenses costing \$48,251 and amortized \$1,118,436. The license rights had a carrying balance of \$10,831,404 as of September 30, 2017.

On December 31, 2015, the Company purchased third-party software licenses in the amount of \$180,000 in anticipation of a large pending deployment that has yet to materialize. The Company is amortizing over the same methodology described above with the greatest of the three approaches being the amortization for the periods. A total of \$2,640 and \$31,356 was expensed for actual sales during the three and nine months ended September 30, 2017, respectively. Since the license purchase, the actual per unit cost (actual usage) of such license rights in the cumulative amount of \$51,036 has been expensed, with a carrying balance of \$128,964 as of September 30, 2017. The Company has classified the balance as non-current until a larger deployment occurs. Software license rights is comprised of the following as of:

	<b>September 30, 2017</b>	<b>December 31, 2016</b>
Current software license rights	\$2,370,000	\$1,560,000
Non-current software license rights	8,590,368	10,598,411
Total software license rights	\$10,960,368	\$12,158,411

The future amortization under the economic use model for the next five years is as follows: 2018 - 2.6 million, 2019 - 3.0 million, 2020 - 2.4 million, 2021 - 1.2 million, and 2022 - 720,000.

#### 8. LOSS PER SHARE COMMON STOCK (“EPS”)

The Company’s basic EPS is calculated using net loss available to common shareholders and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes the effect from potential issuance of common stock, such as stock issuable pursuant to the exercise of stock options and warrants and the assumed conversion of convertible notes and preferred stock.

The reconciliation of the numerators of the basic and diluted EPS calculations was as follows for both of the following three and nine month periods ended September 30, 2017 and 2016:

<b>Three Months ended</b>		<b>Nine Months ended</b>	
<b>September 30, 2017</b>	<b>2016</b>	<b>September 30, 2017</b>	<b>2016</b>

#### **Basic Numerator:**

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Net loss	\$(1,605,784)	\$(1,134,422)	\$(4,751,301)	\$(3,673,125)
Convertible preferred stock dividends	(200,625 )	(200,625 )	(601,875 )	(601,875 )
Net loss available to common stockholders	\$(1,806,409)	\$(1,335,047)	\$(5,353,176)	\$(4,275,000)
Basic Denominator	6,535,449	5,530,105	6,333,530	5,521,218
Per Share Amount	\$(0.28 )	\$(0.24 )	\$(0.85 )	\$(0.77 )

All potential common shares were antidilutive, and accordingly diluted EPS equaled basic EPS for all periods presented in the accompanying financial statements.

The following table sets forth the options and warrants which were excluded from the diluted per share calculation even though the exercise prices were less than the average market price of the common shares because the effect of including these potential shares was antidilutive due to the net losses for the three and nine months ended September 30, 2017 and 2016:

	<b>Three Months ended</b>		<b>Nine Months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Preferred stock	5,416,667	5,416,667	5,416,667	5,416,667
Stock options	205,497	28,992	101,327	13,398
Warrants	9,492	6,529	5,608	-
Total	5,631,656	5,452,188	5,523,602	5,430,065

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

	<b>Three Months ended</b>		<b>Nine Months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Stock options	262,094	215,000	278,761	231,667
Warrants	1,351,052	1,656,702	1,351,052	1,704,618
Total	1,613,146	1,871,702	1,629,813	1,936,285

## 9. STOCKHOLDERS' EQUITY

### 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. As of September 30, 2017, 100,000 shares of preferred stock have been designated as Series A-1 Convertible Preferred Stock (the "Series A-1 Shares"), of which 90,000 shares are issued and outstanding, and 105,000 shares of preferred stock have been designated as Series B-1 Convertible Preferred Stock (the "Series B-1 Shares"), all of which are issued and outstanding.

### Series A-1 Convertible Preferred Stock

On October 22 and 29, 2015, the Company issued 84,500 shares of Series A-1 Convertible Preferred Stock at a purchase price of \$100.00 per share, for aggregate gross proceeds of \$8,450,000. On November 11, 2015, 5,500 additional shares of Series A-1 Convertible Preferred Stock were issued at a purchase price of \$100.00 per share, for gross cash proceeds of \$550,000. Shares of the Series A-1 Convertible Preferred Stock are convertible at any time at the option of the holder into shares of common stock by dividing the Series A-1 Original Issue Price by an initial conversion price of \$3.60 per share, subject to adjustment for stock dividends, stock splits, combinations, and reclassifications of the Company's capital stock, and subject to a "blocker provision" which prohibits conversion if such conversion would result in the holder being the beneficial owner of in excess of 9.99% of the Company's common stock. The Series A-1 Shares accrue dividends at the rate of 6% per annum payable quarterly on April 1, July 1,



October 1, and January 1 of each year. Unless holders of at least a majority of the outstanding shares of Series A-1 Preferred Stock elect otherwise by written notice to the Company, until October 1, 2017, the dividends are payable in cash provided that if payment in cash would be prohibited under applicable Delaware corporation law or cause the Company to breach any agreement for borrowed money, such dividends are payable in kind through the issuance of additional shares of common stock having a value equal to the volume weighted average trading price of the Company's common stock for the ten (10) days preceding the applicable dividend payment date. Commencing January 1, 2018, dividends are payable at the option of the Company in cash or kind through the issuance of additional shares of common valued as described above.

The holders of the Series A-1 shares are entitled to designate one person to serve on the Board of Directors of the Company. The holders of the Series A-1 Shares are entitled to vote on an as converted to common stock basis together with the holders of our common stock on all matters presented to our stockholders. Upon any liquidation or dissolution of the Company, any merger or consolidation involving the Company or any subsidiary of the Company in which the shares of capital stock of the Company outstanding immediately prior to such merger or consolidation do not represent immediately following such merger or consolidation at least a majority of the voting power of the capital stock of the resulting or surviving corporation, or the sale of all or substantially all assets in a single transaction or a series of related transactions, unless the holders of at least a majority of the outstanding Series A-1 Shares elect otherwise, holders of Series A-1 Shares shall be entitled to receive prior to any payment to any holders of the Company's common stock an amount per share equal to \$100.00 per share plus any declared and unpaid dividends (pari-passu with the holders of Series B-1 Shares). On September 22, 2017, a holder of the Series A-1 Shares elected to convert \$540,000 in accrued dividends payable into 150,000 shares of common stock at a conversion price of \$3.60 as agreed, due to the conversion before the December 31, 2017 contractual term. As of September 30, 2017, \$135,000 was accrued for the holders of the Series A-1 Shares, for October 1, 2017 dividends. As of December 31, 2016, \$270,000 of dividends were accrued for the holders of the Series A-1 Shares for October 1, 2016 and January 1, 2017 dividends.

The Series A-1 Preferred Stock contains options that based on an evaluation of FASB ASC 815-15, "Embedded Derivatives" and FASB ASC 815-40-15, "Contracts in Entity's Own Equity - Scope and Scope Exceptions," are considered embedded features: Preferred Stock's conversion option: The Preferred Stock is convertible at the Holder's option at any time at the fixed conversion price of \$3.60 per share; Quarterly Dividend Conversion Option: From issuance until December 31, 2017, the majority of Holders may elect to have the Stock's Quarterly dividend payment made in shares of Common Stock, having a value equal to the volume weighted average trading price of the Common Stock during the ten (10) trading day period preceding the applicable dividend payment date. These features were analyzed by the Company and determined that they were not required to be bifurcated from the preferred stock and recorded as derivatives as they are clearly and closely related to an equity host.

### Series B-1 Convertible Preferred Stock

On November 11, 2015, the Company issued 105,000 shares of Series B-1 Convertible Preferred Stock at a purchase price of \$100.00 per share, for gross proceeds of \$10,500,000. Shares of the Series B-1 Convertible Preferred Stock are convertible at any time at the option of the holder into shares of common stock by dividing the Series B-1 Original Issue Price by an initial conversion price of \$3.60 per share, subject to adjustment for stock dividends, stock splits, combinations, and reclassifications of the Company's capital stock, and subject to a "blocker provision" which prohibits conversion if such conversion would result in the holder being the beneficial owner of in excess of 9.99% of the Company's common stock. The Series B-1 Shares accrue dividends at the rate of 2.5% per annum payable quarterly on April 1, July 1, October 1, and January 1 of each year payable in cash provided that if payment in cash would be prohibited under applicable Delaware corporation law or cause the Company to breach any agreement for borrowed money, or if the majority of the outstanding shares of the Series B-1 Shares elect otherwise, such dividends are payable in kind through the issuance of additional shares of common stock having a value equal to the volume weighted average trading price of the Company's common stock for the ten (10) days preceding the applicable dividend payment date.

The holders of the Series B-1 Shares are entitled to designate one person to serve on the Board of Directors of the Company. The holders of the Series B-1 Shares are entitled to vote on an as converted to common stock basis together with the holders of our common stock on all matters presented to our stockholders. Upon any liquidation or dissolution of the Company, any merger or consolidation involving the Company or any subsidiary of the Company in which the shares of capital stock of the Company outstanding immediately prior to such merger or consolidation do not represent immediately following such merger or consolidation at least a majority of the voting power of the capital stock of the resulting or surviving corporation, or the sale of all or substantially all assets in a single transaction or a series of related transactions, unless the holders of at least a majority of the outstanding Series B-1 Shares elect otherwise, holders of Series B-1 Shares shall be entitled to receive prior to any payment to any holders of the Company's common stock an amount per share equal to \$100.00 per share plus any declared and unpaid dividends (pari-passu with the Series A-1 holders). As of September 30, 2017, \$328,125 was accrued for the holders of the Series B-1 Shares, for October 1, 2016, January 1, 2017, April 1, 2017, July 1, 2017, and October 1, 2017 dividends. As of December 31, 2016, \$131,250 of dividends were accrued for the holders of the Series B-1 Shares for October 1, 2016 and January 1, 2017 dividends.

The Series B-1 Shares contain options that based on an evaluation of FASB ASC 815-15, "Embedded Derivatives" and FASB ASC 815-40-15, "Contracts in Entity's Own Equity - Scope and Scope Exceptions," are considered embedded features: Preferred Stock's conversion option: The Preferred Stock is convertible at the Holder's option at any time at the fixed conversion price of \$3.60 per share; Quarterly Dividend Conversion Option: The majority of Holders may elect to have the Stock's Quarterly dividend payment made in shares of Common Stock, having a value equal to the volume weighted average trading price of the Common Stock during the ten (10) trading day period preceding the applicable dividend payment date. These features were analyzed by the Company and determined that they were not required to be bifurcated from the preferred stock and recorded as derivatives as they are clearly and closely related to an equity host.

Common Stock

Effective December 29, 2016, the Company implemented a reverse stock split of its outstanding common stock at a ratio of 1-for-12. The number of authorized shares and the par value of the Company's common stock and preferred stock were not affected by the reverse stock split. Stockholders who otherwise would be entitled to receive fractional shares were rounded up to the nearest whole share. The reverse stock split became effective on the OTCQB at the opening of trading on December 29, 2016.

On March 15, 2017, the Company issued 1,895 shares of common stock to its directors in payment of board fees, valued at \$5,003. On March 8, 2016, the company issued 8,333 shares of common stock to its directors in payment of board fees valued at \$16,000.

On April 28, 2017, the Company issued to Wong Kwok Fong, a director and executive officer of the Company, 277,778 shares of common stock at a purchase price of \$3.60 per share for gross cash proceeds of \$1,000,000.

On May 2, 2017, the Company entered into a committed equity facility pursuant to which it may issue and sell up to \$5.0 million worth of shares of common stock, subject to certain limitations and satisfaction of certain conditions, over a 36-month term following the effectiveness of a registration statement covering the public resale of the shares of common stock issued under the facility. From time to time over the term of the facility, the Company may issue requests to the investor to purchase a specified dollar amount of shares up to a maximum of \$100,000 over a five trading day period based on the daily volume weighted average price of the Company's common stock (VWAP) to the extent the VWAP equals or exceeds the greater of a formula amount or \$3.83 per share. The per share purchase price for the shares issued under the facility will be equal to 94% of the lowest VWAP that equals or exceeds \$3.83 per share. Aggregate sales under the facility are limited to 19.99% of the total outstanding shares of the Company's common stock as of May 2, 2017, unless stockholder approval is obtained, and sales under the facility are prohibited if such a sale would result in beneficial ownership by the investor of more than 9.99% of the Company's common stock.

On May 11, 2017, the Company issued 1,925 shares of common stock to its directors in payment of board fees, valued at \$5,005. On May 11, 2016, the Company issued 3,431 shares of common stock to its directors in payment of board fees valued at \$6,999. On May 11, 2016, the Company issued 8,333 shares of common stock to the Chief Executive Officer as compensation valued at \$17,000.

In May 2017, the Company issued 55,000 shares of common stock in payment of a commitment fee for the equity facility valued at \$198,000. The Company immediately expensed the fee as it relates to the contingent use of the equity committed equity facility.

In May 2017, the Company issued 61,667 shares of common stock to a consultancy firm in lieu of payment for services with respect to the equity facility agreement. The fair value at issuance averaged \$2.54 per share, with the total amount of \$156,584. The Company deferred the cost to prepaid expense and is amortizing the expense over the length of the consultancy service agreement.

On August 9, 2017, the Company issued 5,148 shares of common stock to its directors in payment of board fees valued at \$18,018. On August 10, 2016, the Company issued 3,125 shares of common stock to its directors in payment of board fees valued at \$9,000.

On September 22, 2017, the Company issued to Wong Kwok Fong (Kelvin), a director and executive officer of the Company, 427,778 shares of common stock and warrants to purchase 138,889 shares of common stock for the aggregate purchase price of \$1,540,000, or \$3.60 per share. The purchase price was paid via a cash payment of \$1,000,000 and the conversion of an accrued dividend payable in the amount of \$540,000 on the Company's Series A-1 Convertible Preferred Stock.

During the three and the nine months ended September 30, 2017, 4,167 employee stock options were exercised resulting in the cashless issuance of 1,610 shares of common stock. There were no stock options exercised during the three and nine months ended September 30, 2016.

#### Stock Issuance Costs

For the nine months ended September 30, 2017, \$80,366 were incurred in relation to the issuance of stock.

#### Derivative Liabilities

In connection with the issuances of equity instruments or debt, the Company may issue options or warrants to purchase common stock. In certain circumstances, these options or warrants may be classified as liabilities, rather than as equity. In addition, the equity instrument or debt may contain embedded derivative instruments, such as conversion options or listing requirements, which in certain circumstances may be required to be bifurcated from the associated host instrument and accounted for separately as a derivative liability instrument. The Company accounts for derivative liability instruments under the provisions of FASB ASC 815, "Derivatives and Hedging."

#### Securities Purchase Agreements dated October 25, 2013 and November 8, 2013

Pursuant to a series of Private Investors Securities Purchase Agreements (the "PI SPA"), on October 25, 2013 and November 8, 2013, the Company issued to certain private investors an aggregate of 1,026,972 units consisting of 1,026,972 shares of common stock (the "Shares") and warrants to purchase an additional 1,026,972 shares of common stock (the "Warrants") for an aggregate purchase price of \$3,697,100. The warrants were immediately exercisable at an exercise price of \$6.00 per share, and had a term of three years which expired in 2016.

In connection with the share issuances described above, and pursuant to a placement agency letter agreement, the Company paid the placement agent cash commissions equal to 8% of the gross proceeds of the offering, reimbursed the placement agent for its reasonable out of pocket expenses, and issued to the placement agent warrants (the "Placement Agent Warrants") to purchase an aggregate of 82,158 shares of common stock. The Placement Agent Warrants have substantially the same terms as the warrants issued to the investors, except the Placement Agent Warrants were immediately exercisable on a cashless basis.



The cashless exercise features contained in the warrants were considered to be derivatives and the Company recorded warrant liabilities on the consolidated balance sheet. The Company initially recorded the warrant liabilities equal to their estimated fair value of \$325,891. Such amount was also recorded as a reduction of additional paid-in capital. The Company is required to mark-to-market the warrant liabilities at the end of each reporting period. For the three months ended September 30, 2016, the Company recorded a gain on the change in fair value of the cashless exercise features of \$4,368. For the nine months ended September 30, 2016, the Company recorded a gain on the change in the fair value of the cashless exercise feature of \$6,272. As of December 31, 2016, the fair value of the cashless exercise features was \$0 as the underlying warrants expired during the fourth quarter of 2016.

#### Securities Purchase Agreement dated November 13, 2014

Pursuant to a Securities Purchase Agreement, dated November 13, 2014, by and between the Company and a number of private and institutional investors (the “November 2014 Private Investor SPA”), the Company issued to certain private investors 664,584 shares of common stock and warrants to purchase an additional 996,877 shares of common stock for aggregate gross proceeds of \$1,595,000.

The common stock had a purchase price reset feature. If at any time prior to the two year anniversary of the effective date of the registration statement covering the public resale of such shares (January 29, 2015), the Company sells or issues shares of common stock or securities that are convertible into common stock at a price lower than \$2.40 per share, the Company will be required to issue additional shares of common stock for no additional consideration.

Based on an evaluation as discussed in FASB ASC 815-15, “Embedded Derivatives” and FASB ASC 815-40-15, “Contracts in Entity’s Own Equity - Scope and Scope Exceptions,” the Company determined that the purchase price reset feature on the common stock issued was not considered indexed to its own stock because neither the occurrence of a sale of equity securities by the issuer at market nor the issuance of another equity contract with a lower strike price is an input to the fair value of a fixed-for-fixed option or forward on equity shares. As such, the purchase price reset feature should be bifurcated from the common stock and accounted for as a derivative liability.

The Company valued the purchase price reset feature using a Monte Carlo simulation at the date of issuance, and at quarterly reporting intervals until the expiration of the feature in January 2017, and determined that the purchase price reset feature had no value as the Company issued Series A-1 and Series B-1 preferred stock in October and November of 2015, at a conversion price of \$3.60, and issued common stock in November 2016 and April 2017 also at a price of \$3.60.

The warrants have a term of five years and an exercise price of \$3.60 per share, and have been fully exercisable since February 2015. The warrants have customary anti-dilution protections including a “full ratchet” anti-dilution adjustment provision which are triggered in the event the Company sells or grants any additional shares of common stock, options, warrants or other securities that are convertible into common stock at a price lower than \$3.60 per share. The anti-dilution adjustment provision is not triggered by certain “exempt issuances” which among other issuances, includes the issuance of shares of common stock, options or other securities to officers, employees, directors, consultants or service providers.

As a result of the early adoption of ASU 2017-11 referred to in Note 1 – Recently Issued Accounting Pronouncements, the “full ratchet” anti-dilution feature is no longer a determinant for derivative liability accounting. As the “full ratchet” anti-dilution feature was determined to have no value in the past, the adoption had no effect on the balance sheets or statements of operations.

### Warrants

On March 9, 2015, the Company issued a warrant to purchase 47,917 shares of common stock to a consultant which vested in equal quarterly installments over one year and is exercisable at \$2.52 per share through March 8, 2020. For the three and nine months ended September 30, 2016, the Company recorded an expense of \$0 and \$11,625 related to the stock warrants. The service period was completed on March 8, 2016.

On September 23, 2015, the Company issued a warrant to purchase 69,445 shares of common stock in connection with the issuance of a promissory note. The warrants are immediately exercisable at an exercise price of \$3.60 per share and have a term of five years.

The warrants have customary anti-dilution protections including a "full ratchet" anti-dilution adjustment provision which are triggered in the event the Company sells or grants any additional shares of common stock, options, warrants or other securities that are convertible into common stock at a price lower than \$3.60 per share. The anti-dilution adjustment provision is not triggered by certain "exempt issuances" which among other issuances, includes the issuance of shares of common stock, options or other securities to officers, employees, directors, consultants or service providers.

As a result of the early adoption of ASU 2017-11 referred to in Note 1 – Recently Issued Accounting Pronouncements, the “full ratchet” anti-dilution feature is no longer a determinant for derivative liability accounting. As the “full ratchet” anti-dilution feature was determined to have no value in the past, the adoption had no effect on the balance sheets or statements of operations.





The cashless exercise features contained in the warrants were initially considered to be derivatives and the Company recorded a warrant liability of \$92,199 on the consolidated balance sheet. The warrants issued by the Company were valued using an option-pricing model. The Company marked-to-market the warrant liabilities at the end of each reporting period. During the quarter ended September 30, 2016, the Company determined the cashless exercise features did not meet the criteria for recording a warrant liability. Accordingly, the grant date fair value of the warrant liability was transferred to additional paid-in capital and the cumulative loss due to change in the recorded fair value of the liability was reversed during the quarter. For the quarter ended September 30, 2016 the Company recorded income of \$56,017 in order to reverse the net cumulative loss on the warrant liability that had been previously recorded. For the nine months ended September 30, 2016 the Company recorded income on the change in warrant liability of \$4,607. The warrant liability was \$0 as of December 31, 2016.

On September 22, 2017, the Company issued to Wong Kwok Fong, a director and executive officer of the Company, warrants to purchase 138,889 shares of Common Stock in connection with the purchase of 427,778 shares of common stock by Mr. Fong. The warrants are immediately exercisable at an exercise price of \$3.60 per share and have a term of five years.

#### Issuances of Stock Options

On March 15, 2017, the Company issued options to purchase 40,000 shares of the Company's common stock to four non-employee members of the Board of Directors. On March 15, 2017, the Company also issued options to purchase 4,167 shares of the Company's common stock to an employee. The options have a three-year vesting period, seven-year term, and exercise price of \$2.64. The options were estimated on the date of grant at \$100,602 using the Black-Scholes option-pricing model with the following assumptions: risk free interest rate: 1.91 %, expected life of options in years: 4.5, expected dividends: 0, volatility of stock price: 138 %.

On March 16, 2017, the Board of Directors issued options to purchase 1,120,000 shares of the Company's common stock to certain officers, employees, and contractors. The options have a three-year vesting period, seven-year term, and exercise price of \$2.65. The options were estimated on the date of grant at \$2,560,081 using the Black-Scholes option-pricing model with the following assumptions: risk free interest rate: 1.91 – 2.11 %, expected life of options in years: 4.5 – 7.0, expected dividends: 0, volatility of stock price: 138 %.

On April 10, 2017, the Company issued options to purchase 10,000 shares of the Company's common stock to a newly appointed Director. The options have a three-year vesting period, seven-year term, and exercise price of \$2.64. The options were estimated on the date of grant at \$20,538 using the Black-Scholes option-pricing model with the following assumptions: risk free interest rate: 1.81%, expected life of options in years: 4.5, expected dividends: 0, volatility of stock price: 138%.

On August 9, 2017, the Company issued options to purchase 60,000 shares of the Company's common stock to certain officers, employees, and contractors. The options have a three-year vesting period, seven-year term, and exercise price of \$3.50.

The fair value of the options issued during the three months ended September 30, 2017 on August 9, 2017 was estimated on the date of grant at \$179,220 using the Black-Scholes option-pricing model with the following assumptions: risk free interest rate: 1.73%, expected life of options in years: 4.5, expected dividends: 0, volatility of stock price: 135%.

## 10. SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of biometric products. Geographically, North American sales accounted for approximately 81% and 90% of the Company's total sales for the three months ended September 30, 2017 and 2016, respectively, and were approximately 75% and 84% of the Company's total sales for the nine months ended September 30, 2017 and 2016, respectively.

## 11. FAIR VALUES OF FINANCIAL INSTRUMENTS

Cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, and due from factor, are carried at, or approximate, fair value because of their short-term nature.

## 12. MAJOR CUSTOMERS AND ACCOUNTS RECEIVABLE

For the three months ended September 30, 2017 and 2016, two customers accounted for 45% and two customers accounted for 44% of revenue, respectively. For the nine months ended September 30, 2017 and 2016, two customers accounted for 32% and one customer accounted for 22% of revenue, respectively.

At September 30, 2017, one customer accounted for 44% of accounts receivable. One customer accounted for 100% of non-current accounts receivable as of September 30, 2017 and December 31, 2016. Based on prior history with this customer, the Company believes the amount is fully collectable, however, the Company has reserved \$1,000,000 which represents 48% of the remaining balance owed under the contract, due to the length of time the receivable has been outstanding. At December 31, 2016, one customer accounted for 81% of current accounts receivable.

## 13. SUBSEQUENT EVENTS

On August 7, 2017, the Company received written notice from Wong Kwok Fong, the holder of an aggregate of 90,000 shares of the Company's Series A-1 Convertible Preferred Stock, of his desire to increase the maximum percentage of shares of common stock issuable upon conversion of the Series A-1 Convertible Preferred Stock from 9.99% to 35%. In accordance with the Certificate of Designation of the Series A-1 Shares, such notice became effective on the 61st day following the date such notice was provided to the Company. On October 17, 2017, Wong Kwok Fong converted 27,404 of the Series A-1 Shares at a conversion price of \$3.60 per share resulting in the acquisition of 761,222 shares of the Company's Common Stock

On November 6, 2017, we issued a warrant to purchase 100,000 shares of common stock to a consultancy firm in payment of consulting services.

On November 13, 2017, we issued 2,276 shares of common stock to four non-employee directors in payment of directors' fees.

The Company has reviewed all other subsequent events through the date of filing.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS**

### **CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS**

The information contained in this Report on Form 10-Q and in other public statements by the Company and Company officers include or may contain certain forward-looking statements. All statements other than statements of historical facts contained in this Report on Form 10-Q, 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. These forward-looking statements are not guarantees and are subject to known and unknown risks, uncertainties and assumptions that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such 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. Particular uncertainties that could cause our actual results to be materially different than those expressed in our forward-looking statements include: our history of losses and limited revenue; our ability to raise additional capital; our ability to protect our intellectual property; changes in business conditions; changes in our sales strategy and product development plans; changes in the marketplace; continued services of our executive management team; security breaches; competition between us and other companies in the biometric technology industry; market acceptance of biometric products generally and our products under development; our ability to expand into the Asian market; delays in the development of products and statements of assumption underlying any of the foregoing, as well as other factors set forth under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2016 filed with the Securities and Exchange Commission. All subsequent written and oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by the foregoing. Except as required by law, we undertake no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

## OVERVIEW

We develop and market advanced fingerprint biometric identification and identity verification technologies, cryptographic authentication-transaction security technologies, as well as related identity management and credentialing software solutions. We were pioneers in developing automated, finger identification technology that supplements or complements other methods of identification and verification, such as personal inspection identification, passwords, tokens, smart cards, ID cards, PKI, credit card, passports, driver's licenses, OTP or other form of possession or knowledge-based credentialing. Advanced BIO-key® technology has been and is used to improve both the accuracy and speed of competing finger-based biometrics. Our solutions are used by many customers in numerous sectors of our economy, including government, retail, healthcare and financial services.

In 2016, we began to distribute directly to consumers and commercial users our SideSwipe™, SideTouch™, and EcoID™ products. SideSwipe, SideTouch, and EcoID are stand-alone fingerprint readers that can be used on any laptop, tablet or other device with a USB port.

At the Consumer Electronics Show 2017, we introduced a number of new products. These included TouchLock, fingerprint biometric and bluetooth enabled padlocks, FreePass, a wearable, mobile USB fingerprint reader, Q-180 Touch, a Micro USB compatible fingerprint reader for Android devices, and SidePass, a compact, square, touch reader for Windows devices. We started distribution of the TouchLock padlock in the Asia Pacific market in June of 2017 and August of 2017 in the US.

We have developed what we believe is the most discriminating and effective commercially available finger-based biometric technology. Our primary focus is in marketing and selling this technology into commercial logical and physical privilege entitlement & access control markets. Our primary market focus includes, among others, mobile payments & credentialing, online payments and credentialing, and healthcare record and payment data security. Our secondary focus includes government and educational markets.

We continue to develop advancements in our capabilities, as well as explore potential strategic relationships, including business combinations and acquisitions, which could help us leverage our capability to deliver our solutions. We have built a direct sales force, and also utilize distributors, resellers, integrators and partners with substantial experience in selling technology solutions to government and corporate customers in their respective markets.

## STRATEGIC OUTLOOK AND RECENT DEVELOPMENTS

Historically, our largest market has been access control within highly regulated industries such as healthcare. However, we believe the mass adoption of advanced smart-phone and hand-held wireless devices have caused commercial demand for advanced user authentication to emerge as viable. The introduction of smart-phone capabilities, like mobile payments and credentialing, could effectively require biometric user authentication on mobile devices to reduce risks of identity theft, payment fraud and other forms of fraud in the mobile or cellular based world wide web. As more services and payment functionalities, such as mobile wallets and near field communication (NFC), migrate to smart-phones, the value and potential risk associated with such systems should grow and drive demand and adoption of advanced user authentication technologies, including fingerprint biometrics and BIO-key solutions.

As devices with onboard fingerprint sensors continue to deploy to consumers, we expect that third party application developers will demand the ability to authenticate users of their respective applications (app's) with the onboard fingerprint biometric. We further believe that authentication will occur on the device itself for potentially low-value, and therefore low-risk, use-transactions and that user authentication for high-value transactions will migrate to the application provider's authentication server, typically located within their supporting technology infrastructure, or cloud. We have developed our technology to enable on-device authentication as well as network or cloud-based authentication and believe we may be the only technology vendor capable of providing this flexibility and capability. Our core technology works on over 40 commercially available fingerprint readers, across both Windows and Linux platforms, and Apple iOS and Android mobile operating systems. This interoperability, coupled with the ability to authenticate users via the device or cloud, is unique in the industry, provides a key differentiator for us, and in our opinion, makes our technology more viable than competing technologies and expands the size of the overall market for our products.

The introduction of the TouchLock, fingerprint biometric and bluetooth (cell phone) enabled padlocks, opens up an additional consumer market for us. As a security solution, we also have a version of the lock that is TSA compatible, to allow travelers to lock their luggage which TSA can open and relock.

We believe there is potential for significant market growth in six key areas:

Corporate network access control, including corporate campuses, computer networks and applications;

Consumer mobile credentialing, including mobile payments, credit and payment card programs, data and application access, and commercial loyalty programs;

Government services and highly regulated industries including, Medicare, Medicaid, Social Security, drivers licenses, campus and school ID, passports/visas;

Direct sales of fingerprint readers to consumers and commercial customers;

Direct sales of biometric locks to consumers and commercial customers; and

Growth in the Asia Pacific region.

In the near-term, we expect to grow our business within government services and highly-regulated industries in which we have historically had a strong presence, such as the healthcare industry. We believe that continued heightened security and privacy requirements in these industries will generate increased demand for security solutions, including biometrics. In addition, we expect that the integration of our technology into Windows 10, will accelerate the demand for our computer network log-on solutions and fingerprint readers. We are also experiencing growth in our hardware offerings as we continue to develop our products business. Finally, our entry into the Asian market and licensing arrangement with China Goldjoy Group has further expanded our business, particularly our hardware business, by opening new markets.

Over the longer term, we intend to expand our business into the cloud and mobile computing industries. The emergence of cloud computing and mobile computing are primary drivers of commercial and consumer adoption of advanced authentication applications, including biometric and BIO-key authentication capabilities. As the value of assets, services and transactions increases on such networks, we expect that security and user authentication demand should rise proportionately. Our integration partners include major web and network technology providers, who we believe will deliver our cloud-applicable solutions to interested service-providers. These service-providers could include, but are not limited to, financial institutions, web-service providers, consumer payment service providers, credit reporting services, consumer data service providers, healthcare providers and others. Additionally, our integration partners include major technology component providers and OEM manufacturers, who we believe will deliver our device-applicable solutions to interested hardware manufacturers. Such manufacturers could include cellular handset and smartphone manufacturers, tablet manufacturers, laptop and PC manufacturers, among other hardware manufacturers.



## **CRITICAL ACCOUNTING POLICIES**

For detailed information regarding our critical accounting policies and estimates, see our financial statements and notes thereto included in this Report and in our Annual Report on Form 10-K for the year ended December 31, 2016. There have been no material changes to our critical accounting policies and estimates from those disclosed in our most recent Annual Report on Form 10-K.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

For detailed information regarding recent account pronouncements, see Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report.

**RESULTS OF OPERATIONS****THREE MONTHS ENDED SEPTEMBER 30, 2017 AS COMPARED TO SEPTEMBER 30, 2016****Consolidated Results of Operations - Percent Trend**

	<b>Three Months Ended</b>		<b>September 30, 2017</b>		<b>2016</b>	
<b>Revenues</b>						
Services	40	%	43	%		
License fees and other	6	%	6	%		
Hardware	54	%	51	%		
	100	%	100	%		
<b>Costs and other expenses</b>						
Cost of services	20	%	11	%		
Cost of license fees, hardware and other	78	%	29	%		
	98	%	40	%		
Gross Profit	2	%	60	%		
<b>Operating expenses</b>						
Selling, general and administrative	131	%	214	%		
Research, development and engineering	41	%	123	%		
	172	%	337	%		
<b>Operating loss</b>	-170	%	-277	%		
<b>Other income (deductions)</b>						
Total other income	-	%	14	%		
<b>Net loss</b>	-170	%	-263	%		

***Revenues and cost of goods sold*****Three months  
ended****September 30,  
2017**      **2016**

			\$ Change	% Change	
<i>Revenues</i>					
Service	\$377,113	\$187,025	\$190,088	102	%
License & other	53,023	25,435	27,588	108	%
Hardware	512,281	219,003	293,278	134	%
<i>Total Revenue</i>	\$942,417	\$431,463	\$510,954	118	%
<i>Cost of goods sold</i>					
Service	\$190,889	\$46,257	\$144,632	313	%
License, hardware & other	732,192	125,526	606,666	483	%
<i>Total COGS</i>	\$923,081	\$171,783	\$751,298	437	%

***Revenues***

For the three months ended September 30, 2017 and 2016, service revenues included approximately \$117,000 and \$182,000, respectively, of recurring maintenance and support revenue, and approximately \$260,000 and \$5,400 respectively, of non-recurring custom services revenue. Recurring service revenue decreased 36% in 2017 due to the non-renewal of two large maintenance contracts. The increase in non-recurring custom services revenues resulted from a special software requirement from an existing customer.

For the three months ended September 30, 2017, license and other revenue (royalties) increased 108% from the corresponding period in 2016, from both new and existing customers.

Hardware sales increased by approximately \$293,000 (134%), as a result of an increase in existing and new customer deployments. During the three months ended September 30, 2017, we continued to ship our new line of biometric locks in the amount of approximately \$164,000.

***Costs of goods sold***

For the three months ended September 30, 2017, cost of service increased 313%, due to added resources and reallocated research and development personnel to support the custom services revenue.



License, hardware and other costs for the three months ended September 30, 2017 increased approximately 483%. The increase was directly associated with the costs of the hardware mix, and \$388,681 was directly associated with the amortization of the software rights.

***Selling, general and administrative***

	<b>Three months ended</b>			
	<b>September 30,</b>		<b>\$</b>	<b>%</b>
	<b>2017</b>	<b>2016</b>	<b>Change</b>	<b>Change</b>
<b>Selling, general and administrative</b>	\$1,238,296	\$925,939	\$312,357	34 %

Selling, general and administrative costs for the three months ended September 30, 2017 increased 34% from the corresponding period in 2016. The increase is attributable to additional expenses related to our Hong Kong subsidiary, commitment fees, non- cash compensation, Nasdaq related fees, and commissions, offset by lower legal fees.

***Research, development and engineering***

	<b>Three months ended</b>			
	<b>September 30,</b>		<b>\$</b>	<b>%</b>
	<b>2017</b>	<b>2016</b>	<b>Change</b>	<b>Change</b>
<b>Research, development and engineering</b>	\$386,830			