BIO KEY INTERNATIONAL INC
Form 10KSB/A
June 19, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB/A

Amendment No. 2

Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2005

Commission File Number 1-13463

BIO-KEY INTERNATIONAL, INC.

(Name of small business issuer in its charter)

DELAWARE	**41-1741861**
(State or other jurisdiction of Incorporation or organization)	(IRS Employer Identification Number)

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

(Address of Principal Executive Offices) (Zip Code)

(732) 359-1100

Issuer s telephone number, including area code.

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

Title of Each Class	**Name of Exchange on which Registered**
Common Stock, $0.0001 par value per share	None

Securities registered under Section 12(g) of the Exchange Act

None

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 x No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrants knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this form 10-KSB. x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

State issuer s revenues for its most recent fiscal year: $14,226,095

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant based on the closing sale price of the registrant common stock as reported on the OTC Bulletin Board on March 15, 2006 was $23,132,637. The information provided shall in no way be construed as an admission that any person whose holdings are excluded from the figure is an affiliate or that any person whose holdings are included in the figure is not an affiliate, and any such admission is hereby disclaimed. The information provided is solely for the record keeping purposes of the Securities and Exchange Commission.

As of March 15, 2006, 48,036,983 shares of the registrant s common stock were outstanding.

Transitional Small Business Disclosure Formats (check one):

Yes o No x

EXPLANATORY NOTE

This Amendment on Form 10-KSB/A constitutes Amendment No. 2 to the registrant s Annual Report on Form 10-KSB for the period ended December 31, 2005, which was originally filed with the Securities and Exchange Commission on March 30, 2006 (as amended, the Original Report). The purpose of this Amendment No. 2 is to amend the registrant s financial statements and management s discussion and analysis for restatements of the registrant s December 31, 2004 and 2005 annual financial statements as amended, and to provide further clarification under Item 8A (Controls and Procedures). The restatements are further explained in note B of the financial statements. Except as amended hereby, this Form 10-KSB/A does not amend, update or change any other information contained in the Original Report.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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PRIVATE SECURITIES LITIGATION REFORM ACT

All statements other than statements of historical facts contained in this Annual Report on Form 10-KSB, 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-statements. Although we believe our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure they will be achieved. Actual results may differ materially from the forward-looking statements contained herein due to a number of factors. Many of these factors are set forth under the caption Risk Factors in Item I of this Annual Report and other filings with the Securities and Exchange Commission. These factors are not intended to represent a complete list of the general or specific factors that may affect us. It should be recognized that other factors, including general economic factors and business strategies, may be significant, presently or in the future. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

BIO-key International, Inc., a Delaware corporation (the Company, BIO-key, we, or us), was founded in 1993 to develop and market proprietar 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 Delware. 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 the recent mergers, and as discussed in Note M to the Consolidated Financial Statements, we have organized BIO-key International, Inc. 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.

Products

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

Biometrics

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 many complex application systems. VST runs in 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 leverages the power of Oracle for large scale solutions in the millions of users, or uses smaller databases for more modest applications to 100,000 users.

- **WEB-key** ® BIO-key s biometric platform that offers an enhanced level of security by securing the user s authentication with trusted communications and simple use. WEB-key runs on Windows or Linux systems.

- **Biometric Service Provider** BIO-key provides support for the BioAPI (a standards based solution meeting worldwide needs, see *www.bioapi.org* for details) 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 and add a level of security and audit through re-authentication of a user at the transaction level.

The Company s biometric identification technology improves both the accuracy and speed of finger-based biometrics. The Company s proprietary biometric technology scans a fingerprint and identifies a person, typically within a few seconds or less, in databases of a million people or more. BIO-key can accomplish this without using any other identifying data a key differentiator for BIO-key since other biometric solutions may also require traditional token/card identification. BIO-key s core technology supports user enrollment on over 40 different commercially available readers and in turn can offer compatibility among those readers through a single fingerprint template. We have also added INCITS 378-2004 support to our software development kits which makes our products compatible with all of the Registered Traveler projects, PIV initiatives, and FIXS consortium solutions. We believe our fingerprint identification technology has a broad range of possible 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 cell phones and PDA s
- Preventing identity theft with positive identification and false alias validation

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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 1,200 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 police officers and other security personnel instantaneous access to important criminal, civil, and private database information in a wireless environment. PocketCop® is a handheld application that allows law enforcement officers to access state and federal databases over the wireless network for Palm OS, Windows CE, and Pocket PC. 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 departments in the United States, including the deployment for the Massachusetts State Police.

- **IdentityMatch -** a web-based system that allows law enforcement agencies to capture and store fingerprints online 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, not 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.

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.

- **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 and can generate reports.

- **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 so a supervisor can review and approve it. Once complete the report can be printed in the state s format. Only selected states are supported.

- **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.

- **Incident Command -** using FieldSoft s PDonScene, 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.

- **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.

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Fire Safety

In addition to law enforcement/fire service mobile data solutions, BIO-key offers its Sunpro fire service/EMS records management software, FireRMS , that helps large and small agencies manage operations, track incidents and support fire prevention initiatives. FireRMS Mobile provides wireless query and messaging solutions that extend computer aided dispatch, fire records, and other in-house data sources to a mobile environment and provide mission-critical information to emergency response personnel where and when they need it.

- **PacketCluster® Rescue** BIO-key s mobile information solution for fire and EMS, runs off the same server as MobileCop . It provides much of MobileCop functionality without the State/NCIC interface not required by fire service and EMS. Rescue provides mission-critical data such as HAZMAT information and building plans that fire service officers need to know while at a fire scene.

- **FireRMS Records Management Software** this NFIRS 5.0-compliant fire records system helps manage operations, track incidents and support fire prevention initiatives. It is designed to speed data entry and reduce completion time for front-line personnel.

- **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.

- **RMS Interfaces** RMS interfaces provide a mechanism to integrate patient care reports collected in the field with the NIBRS report. 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*r Express from MedDataSolutions enables EMS field data collection for efficient collection of patent data where it is generated.

- **Geographic Data Analysis** FireView from the Omega Group allows Fire and EMS agencies to analyze their deployment strategies.

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

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

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.

- **Provide for device independent finger identification matching** for virtually any application by using the latest advances in scanning technology.

- **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.

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Markets

Law Enforcement

BIO-key s InfoServer , MobileCop and PocketCop® Law Enforcement products are the leading wireless mobile data communications client/server solution, implemented in more than 1,200 agencies nationwide. Providing immediate access to mission-critical data and enabling in-field reporting, BIO-key software keeps officers on the street, improving their productivity and enhances 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 proven 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 1,200 law enforcement agencies continues to be a strength that helps leverage additional sales from both existing customers and new customers. 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 can run on any and all wireless infrastructures. BIO-key also has proven success implementing seamless roaming across multiple infrastructures for multi-agency consortiums.

• BIO-key s open architecture.

• BIO-key has 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 IdentityMatch fingerprint identification solution, which lets law enforcement personnel capture fingerprints in the field and, using BIO-key s patented Vector Segment Technology®, then analyzes and categorizes fingerprints the same way a fingerprint expert would only faster. IdentityMatch 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, present opportunities for the law enforcement business segment in the coming year.

Fire Safety

BIO-key s FireRMS fire records management software is a flexible solution available for Fire Service and EMS agencies. It is a comprehensive collection of modules that manage a range of activities from daily scheduling to vehicle maintenance. FireRMS streamlines data collection across all areas of department operations, and integrates with other department systems to provide a seamless solution for data access, whether in the station or on the scene of an incident. In addition to helping first responders efficiently deliver traditional fire safety and services and respond to massive emergency situations, it enables adherence to NFIRS, NEMSIS, HIPAA, and ISO requirements. The solutions also bring the station into the field with mobile data communications solutions, and most recently, FireRMS Mobile, which brings the capabilities of FireRMS to first responders where and when they most need to report and access critical information.

• *Growth potential* a growth opportunity for the fire business segment is in the mobile market with the RMS mobile products. BIO-key s FireRMS Mobile solutions extend the power of our FireRMS product to the field. Inspectors, for example, can now perform occupancy inspections over a wireless or synched connection using a pen tablet. This approach eliminates redundant data entry, and provides immediate updates of critical information and notification of violations. Likewise, EMS workers can collect critical patient data and relay the data to medical personnel. This new mobile approach to fire and EMS data collection and access offers great potential among both new and existing

FireRMS customers.

Finger-based Biometric Identification

Finally, 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, Sarbanes-Oxley, and the Electronic Signatures Act. BIO-key couples these capabilities with device interoperability and system flexibility and scalability. BIO-key enables the use of about 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 IdentityMatch , a real-time, in-station solution that allows law enforcement professionals to capture fingerprints from a suspect or captured from a crime scene and compare them to fingerprints. 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 to a pure physical access solution in NextGenID, which has been deployed at BIO-key facilities.

- *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 cutting-edge applications that address growing concerns particularly about identity theft and terrorism.

For example, BIO-key has implemented programs that will enable biometric access. These include a national pilot with a large fitness center chain to provide finger-based membership and access to its locations around the country; with 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.

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, IDENTIX, 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.

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 Printrak, InfoCop 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 solutions may not be as functionally rich as the BIO-key suite of products, they are sometimes less expensive. They also provide a complete solution from one vendor.

Fire Safety

The fire records management market includes a large number of RMS vendors including Firehouse, FDM 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 has strategic alliances with technology leaders including Oracle, Netegrity, Hewlett Packard, Dell, Verizon, Sprint/Nextel, Cingular 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

- 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.

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 safety 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 a 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 Cingular, 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 MobileCOP solution in conjunction with Cingular 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.

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- 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, Northup 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 Office issued us a patent for our Vector Segment fingerprint technology (VST), BIO-key s core biometric analysis and identification 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 , SACman , SACcat , SACremote , True User Identification , WEB-key , Packe PacketCluster Patrol , PacketWriter , PacketBlue , SunPro and the design mark for Ceurulean with the U.S. Patent and Trademark Office. We also applied for trademarks for PocketCop and 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.

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In 2005, BIO-key announced the launch of IdentityMatch, our fingerprint identification system. IdentityMatch offers a tool for agencies to store and search fingerprints and the associated demographic data, the ability to compare new prints with those previously captured as a low-cost AFIS alternative or to be used for a wide variety of routine identification transactions not supported by AFIS. IdentityMatch is currently being tested by a number of customers.

During fiscal years ended December 31, 2004 and 2005, BIO-key spent approximately $2,980,000 and $6,846,000 respectively, on research and development. 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.

RISK FACTORS

The following material risk factors, among others, may affect the Company s financial condition and results of operations.

Business and Financial Risks

Based on our 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, 2005 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, 2005, we had negative working capital of approximately $10,400,000 and an accumulated deficit of approximately $42,762,000. Since our inception, we have focused almost exclusively on developing our core technologies and, until the fourth quarter of 2004 have 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 identified material weaknesses in our internal control over financial reporting and have failed to maintain an effective system of disclosure controls and procedures. If we are unable to successfully address such material weaknesses or if we continue to maintain an ineffective 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.

After a review of our March 31, 2005, June 30, 2005 and September 30, 2005 quarterly operating results, as well as our 2005 annual operating results, conducted pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the Exchange Act), our Co-Chief Executive Officers and our Chief Financial Officer have determined that, as of each such date, our disclosure controls and procedures were not effective to provide reasonable assurance that information that 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 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, 2005 as being inadequate to provide such assistance.

In addition, our independent auditors, DS&B, Ltd., notified the Audit Committee of our Board of Directors on April 18, 2005 that they believed there were reportable conditions during 2004 and 2005 which constituted a material weakness in our internal controls. These weaknesses concerned deficiencies in the design and implementation of our internal controls and the fact that, due to two recent acquisitions, we were not staffed properly in our accounting and reporting department and may not have had appropriate accounting and reporting software. For these reasons, we were not able to meet our schedule for preparing our audit and for filing our annual report on Form 10-KSB for the fiscal year ended December 31, 2004 in a timely manner.

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. We are in the process of addressing these issues to ensure that our internal control over financial reporting and disclosure controls and procedures are improved so as to 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 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 improve the material weaknesses in our internal control over financial reporting and the ineffectiveness of our disclosure controls and procedures will be successful or that we will be able to maintain adequate controls over our financial processes and reporting in the future. We will need to commit 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 or delay to develop or 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, 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 default or error in new or existing software or applications could cause delays in delivering our technology or require design modifications. These could adversely affect our competitive position and cause us to lose potential customers or opportunities. Since our technologies are intended to be utilized to secure physical and electronic access, the effect of any such bugs or delays will likely have a detrimental impact on us. In addition, given that biometric technology generally, and our biometric technology specifically, has yet to gain widespread acceptance in the market, any delays would likely have a more detrimental impact on our business than if we were a more established company.

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

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

We market our technology through licensing arrangements with:

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

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

We 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.

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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 Co-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 Co-Chief Executive Officer could severely and negatively impact our operations. We have had an employment contract with Michael W. DePasquale, our Co-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 can not assure you that the limited intellectual property protection for our core technology provides a meaningful competitive advantage or barrier to entry against our competitors.

Our success and ability to compete is dependent in part upon proprietary rights to our technology. We rely primarily on a combination of patent, copyright and trademark laws, trade secrets and technical measures to protect our propriety rights. We have filed a patent application relating to both the optic technology and biometrics solution components of our technology wherein several claims have been allowed. 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 may need to obtain additional financing to execute our business plan, which may not be available. If we are unable to raise additional capital or generate significant revenue, we may not be able to continue operations.

Since our inception, we have not generated any significant revenue (other than revenue from acquired businesses) and have experienced substantial losses, including approximately $10,221,000 during 2005, excluding the impact related to embedded derivative fair value adjustments. 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 and in January 2006 we received approximately $1,000,000 in another a private placement convertible debt offering. To the extent that we will require additional capital to support our operations, expand our marketing and sales efforts and to execute our business plan to substantially increase revenue, we may need to obtain additional financing through the issuance of debt or equity securities. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. We have not and cannot assure you that we will ever be able to secure any such financing on terms acceptable to us. If we cannot obtain such financing or generate such revenues, we may not be able to execute our business plan or continue operations.

We may not be able to successfully complete the integration of PSG and AMG into our operations.

The integration of PSG and AMG into our operations involves a number of risks, including:

- difficulty integrating operations and personnel;
- diversion of management attention;
- potential disruption of ongoing business;
- inability to retain key personnel;
- inability to successfully incorporate the acquired products and services into our product and service offerings and to develop new products and services; and
- impairment of relationships with employees, customers or vendors.

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

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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 $11.3 million at December 31, 2005, a complete prepayment would require a cash payment of approximately $12.7 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 March 15th, 2006, approximately 45,764,000 shares of our common stock were reserved for issuance upon exercise or conversion of the following securities:

- 15,273,000 shares upon conversion of outstanding convertible term notes;
- 20,729,000 shares upon exercise of outstanding stock options and warrants;
- 1,878,000 shares upon exercise of options available for future grant under our existing option plans; and
- 7,884,000 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 $.70 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 7,287,987 shares of common stock as of December 31, 2005 at a per share conversion price of $.70. 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 have agreed to file a registration statement to cover the public resale of all of these shares. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares and substantially dilute the ownership interests of our existing shareholders. In the event that our stock trades below $.70 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 $.70 per share. Any issuance of shares at a purchase price of less than $.70 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 are convertible into 1,000,000 shares of Series B Convertible Preferred Stock of the Company, which shares are convertible into shares of the Common Stock of the Company at an initial fixed conversion of $0.70 per share for an aggregate amount of 1,428,571 shares. 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 have agreed to file a registration statement to cover the public resale of all of these shares. This significant increase in the number of shares available for public sale may have a negative impact on the trading price of our shares and substantially dilute the ownership interests of our existing shareholders. In the event that our stock trades below $.70 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 $.70 per share. Any issuance of shares at a purchase price of less than $.70 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.

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 can not assure you that any of these firms will continue to serve as market makers or have the financial capability to stabilize or support our common stock. A reduction in the number of market makers or the financial capability of any of these market makers could also result in a decrease in the trading volume of and price of our shares. In recent years broad stock market indices, in general, and the securities of technology companies, in particular, have experienced substantial price fluctuations. Such broad market fluctuations may adversely affect the future-trading price of our common stock.

ITEM 2. DESCRIPTION OF PROPERTY

We do not own any real estate. We conduct operations from leased premises in Marlborough, Massachusetts (38,000 square feet), Eagan, Minnesota (6,800 square feet), Wall, New Jersey (2,180 square feet) and Winter Park, Florida (900 square feet). We believe that our current facilities are adequate for the foreseeable future.

ITEM 3. 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 has since been removed to the United States District Court for the District of Massachusetts at the request of the Parties. The complaint claims that PSG is 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 has denied the allegations and filed an answer in the litigation, and as of the date of this report the outcome of the litigation is pending. The claim is for an unspecified amount including actual damages, interest, and attorney s fees. Management believes the claim is without merit and will settle out of court for an amount, which will not have a material adverse affect on our business, financial condition or operating results.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders in the fourth quarter of 2005.

PART II

ITEM 5. MARKET FOR COMMON EQUITY 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.

2005:	**High**	**Low**
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

2004:	**High**	**Low**
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

2003:	**High**	**Low**
Quarter ended December 31, 2003	$ 1.40	$ 0.53
Quarter ended September 30, 2003	.59	0.38
Quarter ended June 30, 2003	.64	0.30
Quarter ended March 31, 2003	.73	0.35

The last price of our common stock as reported on the OTC Bulletin Board on March 15, 2006 was $0.62 per share.

Holders

As of March 15, 2006, the number of stockholders of record of our common stock was 192. Based on broker inquiry conducted in connection with the distribution of proxy solicitation materials in connection with the Company s special meeting of shareholders in February 2006, we believe that there are approximately 4,816 beneficial owners of our common stock.

Dividends

We have not paid any cash dividends to date, and have no intention of paying any cash dividends on our common stock in the foreseeable future. The terms of our outstanding 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 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.

Recent Sales Of Unregistered Securities.

(a) Between December 11, 2003 and March 2, 2004, the Company issued an aggregate of 4,120,345 shares of common stock upon conversion of $2,538,938 principal amount and $551,321 of accrued interest due under our Secured Convertible Note dated November 26, 2001. The shares were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereunder without payment of underwriting discounts or commission to any person.

(b) On March 3, 2004, the Company issued 65,000 shares of Series C convertible preferred stock to The Shaar Fund Ltd. in exchange for the cancellation of $5,736,232 principal amount of outstanding convertible promissory notes and $763,768 of accrued interest due thereunder. The Series C convertible preferred is convertible at the option of the holder into common stock at a conversion price of $.75 per share, subject to certain anti-dilution adjustments. The securities were issued to one accredited investor in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereunder, without payment of underwriting discounts or commissions to any person.

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(c) On March 30, 2004, the Company issued 5,257 shares of Series C convertible preferred stock to The Shaar Fund Ltd. in exchange for the cancellation of all of our issued and outstanding shares of Series B preferred stock. The Series C convertible preferred are convertible at the option of the holder into common stock at a conversion price of $.75 per share, subject to certain anti-dilution adjustments. The securities were issued to one accredited investor in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereunder, without payment of underwriting discounts or commissions to any person.

(d) On March 30, 2004, the Company issued 18,275 shares of Series C convertible preferred stock to The Shaar Fund Ltd. in exchange for the cancellation of $1,777,500 principal amount of outstanding convertible promissory notes and $49,963 of accrued interest due thereunder. The Series C convertible preferred are convertible at the option of the holder into common stock at a conversion price of $.75 per share, subject to certain anti-dilution adjustments. The securities were issued to one accredited investor in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereunder, without payment of underwriting discounts or commissions to any person.

(e) On March 30, 2004, the Company issued an aggregate of 2,422,108 shares of common stock to ten (10) individuals and Harward Investments, Inc. in connection with the Company s acquisition of Public Safety Group, Inc. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(f) On March 31, 2004, the Company issued an aggregate of 8,888,928 shares of common stock and warrants to purchase 4,444,464 shares of common stock to forty-nine (49) accredited investors for aggregate gross proceeds of approximately $12,000,000 in cash. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(g) On April 29, 2004, the Company issued 3,750 shares of Series C convertible preferred stock to Thomas J. Colatosti in exchange for the cancellation of $375,000 principal amount of outstanding convertible promissory notes. The Series C convertible preferred are convertible at the option of the holder into common stock at a conversion price of $.75 per share, subject to certain anti-dilution adjustments. The securities were issued to one accredited investor in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereunder, without payment of underwriting discounts or commissions to any person.

(h) On September 29, 2004, the Company issued secured convertible term notes in the aggregate principal amount of $5,050,000 and warrants to purchase 1,122,222 shares of common stock at an exercise price of $1.35 per share to Laurus Master Fund, Ltd. and other institutional and accredited investors. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(i) On September 29, 2004, the Company issued secured convertible term notes in the aggregate principal amount of $4,950,000 and warrants to purchase 1,099,997 shares of common stock at an exercise price of $1.35 per share to The Shaar Fund Ltd. and other institutional and accredited investors. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(j) In September 2004, the Company issued consultants warrants to purchase 620,667 shares of the Company s common stock at an exercise price of $1.55 per share. The warrants have a term of five (5) years and vest immediately. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(k) On May 31, 2005, the Company issued secured convertible term notes in the aggregate principal amount of $2,794,723 and warrants to purchase 828,066 shares of common stock at an exercise price of $1.50 per share to The Shaar Fund Ltd. and other institutional and accredited investors. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(l) On June 8, 2005, the Company issued secured convertible term notes in the aggregate principal amount of $2,000,000 and warrants to purchase 444,444 shares of common stock at an exercise price of $1.55 per share to Laurus Master Fund, Ltd. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(m) On August 31, 2005, the Company entered into an Amendment and Waiver with Laurus Master Fund, Ltd.(Laurus) pursuant to which Laurus allowed the Company to defer certain payments of monthly principal due under the Secured Convertible Term Note dated September 29, 2004. The Company issued 612,166 shares of its Common Stock to Laurus as consideration for this principal payment deferral. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(n) On August 31, 2005, the Company entered into an Amendment and Waiver with The Shaar Fund Ltd. and other institutional and accredited investors pursuant to which these investors allowed the Company to defer certain payments of monthly principal due under the Secured Convertible Term Note dated September 29, 2004. The Company issued 263,706 shares of its Common Stock to these investors as consideration for this principal payment deferral. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(o) On January 23, 2006, BIO-key International, Inc. entered into an Amendment and Waiver with Laurus pursuant to which Laurus allowed the Company to extend the maturity of the Secured Convertible Term Notes dated September 29, 2004 and June 7, 2005. 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. The Company issued 150,000 shares of the Company s Common Stock to Laurus as consideration for this payment deferral. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

(p) On January 23, 2006, the Company entered into an Amendment and Waiver with The Shaar Fund Ltd. and other institutional and accredited investors pursuant to which these investors allowed the Company to extend the maturity of the Subordinated Notes issued by the Company on September 29, 2004 and on May 31, 2005. Additionally, the interest rate was fixed at fifteen percent (15%) and 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. 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. 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.

(q) On January 23, 2006, the Company issued Convertible Term Notes in the aggregate principal amount of $1,000,000 to certain investors. The Convertible Notes are convertible into 1,000,000 shares of Shares of Series B Convertible Preferred Stock of the Company at an initial fixed conversion of $0.70 per share for an aggregate amount of 1,428,571 shares. These securities were issued in a private placement transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof directly by the Company without engaging in any advertising or general solicitation of any kind and without payment of underwriting discounts or commissions to any person.

Convertible Preferred Stock

In March 2004, we designated 100,000 shares of preferred stock as Series C Convertible Preferred Stock (the Series A Convertible Preferred Shares). When the Company reincorporated in Delaware, the Series A Convertible Preferred Shares were re-named as Series A Convertible Preferred Stock of which 44,557 are issued and outstanding as of December 31, 2005. The following describes the material provisions of the Series A Convertible Preferred Shares which are more fully set forth in the Certificate of Designation on file with the Delaware Secretary of State.

The Series A Convertible Preferred 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 Convertible Preferred 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 Convertible Preferred Shares are convertible into common stock at a conversion price of $.70 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 Convertible Preferred 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, 2007, we will be required to redeem the Series A Convertible Preferred Shares by payment of $100 per share plus all accrued and unpaid dividends due thereon.

We are required to obtain the consent of the holders of a majority of the Series A 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 A 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 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.

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. 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. 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 $.70 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 A 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

ITEM 6. 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 2005 performance and a description of the significant events impacting 2005 and thereafter.

RESULTS OF OPERATIONS provides an analysis of the consolidated and segment results of operations for 2005 compared to 2004 and 2004 compared to 2003.

LIQUIDITY AND CAPITAL RESOURCES provides an overview of our cash flows, financing, contractual obligations and embedded derivatives activities.

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.

OTHER MATTERS provides a discussion of our significant non-operational items which impact our financial statements, such as the SEC comment letter.

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 2005.

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. We expect to continue to add additional qualified personnel beyond 2005.

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.

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.

INTRODUCTION

During 2005, the Company continued to integrate the products, operations and technology of the Mobile Government business, acquired from Aether Systems in September 2004, in an effort to leverage new business opportunities. Our financial objective is to increase revenue, manage expenses and attain profitability. While total expenses have increased in dollars, they have declined as a percentage of revenue in 2005 and 2004. In the fourth quarter of 2005, the Company restructured its operations into three business segments: Biometrics, Law Enforcement and Fire Safety. Each segment will be 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 will lead 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

Three Year % trend

	Years ended December 31, 2005 (Restated)		2004 (Restated)		2003 (Restated)	
Revenues						
Services	76	%	59	%	5	%
License fees and other	24	%	41	%	95	%
	100	%	100	%	100	%
Costs and other expenses						
Services	20	%	21	%	1	%
Cost of license fees and other	7	%	16	%	41	%
Selling, general and administrative	83	%	124	%	975	%
Research, development and engineering	48	%	52	%	481	%
	158	%	213	%	1,498	%
Operating loss	(58	)%	(113	)%	(1,398	)%
Other income (deductions)						
Total other income (deductions)	(32	)%	(77	)%	(486	)%
NET INCOME (LOSS)	(26	)%	(190	)%	(1,884	)%

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As discussed in Note M to the Consolidated Financial Statements, we have three reporting segments: Law Enforcement, Fire Safety and Biometrics. The Law Enforcement and Fire Safety segments were purchased during 2004. As noted earlier, in the fourth quarter of 2005 the Company restructured its operations into three business segments, 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. The segmentation of operating income as noted above and detailed below reflects how management now evaluates its business. Assets for the company are commingled and are related to all operating segments. Management does not evaluate or identify the operating assets of the segments separately.

	2005	2004 Restated	2003 Restated	2005 - 2004 $ Chg	% Chg	2004 - 2003 $ Chg	% Chg
Revenues							
Law Enforcement							
Service	$ 7,886,000	$ 2,562,136	$	$ 5,323,864	208 %	$ 2,562,136	n/a
License & other	2,638,938	1,920,642		718,296	37 %	1,920,642	n/a
	10,524,938	4,482,778		6,042,160	135 %	4,482,778	n/a
Fire Safety							
Service	2,814,616	693,967		2,120,649	306 %	693,967	n/a
License & other	406,470	187,229		219,241	117 %	187,229	n/a
	3,221,086	881,196		2,339,890	266 %	881,196	n/a
Biometrics							
Service	161,033	95,303	10,694	65,730	69 %	84,609	791 %
License & other	319,038	261,674	204,787	57,364	22 %	56,887	28 %
	480,071	356,977	215,481	123,094	34 %	141,496	66 %
Total Revenue	$ 14,226,095	$ 5,720,951	$ 215,481	$ 8,505,144	149 %	$ 5,505,470	2,555 %
Cost of goods sold							
Law Enforcement							
Service	$ 2,260,845	$ 902,794	$	$ 1,358,051	150 %	$ 902,794	n/a
License & other	679,170	686,806		(7,636)	(1) %	686,806	n/a
	2,940,015	1,589,600		1,350,415	85 %	1,589,600	n/a
Fire Safety							
Service	602,317	253,913		348,404	137 %	253,913	n/a
License & other	165,074	96,081		68,993	72 %	96,081	n/a
	767,391	349,994		417,397	119 %	349,994	n/a
Biometrics							
Service	42,980	17,617	1,694	25,363	144 %	15,923	940 %
License & other	93,247	107,009	87,387	(13,762)	13 %	19,622	22 %
	136,227	124,626	89,081	11,601	9 %	35,545	40 %
Total COGS	$ 3,843,633	$ 2,064,220	$ 89,081	$ 1,779,413	86 %	$ 1,975,139	2,217 %

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Revenues

Law Enforcement

The increase in these revenue components from 2004 is primarily attributable to the fact that the business was acquired in the third quarter of 2004. Therefore 2004 represents only one quarter of revenue, whereas 2005 reflects four quarters of revenue. The increase was partially offset with a reduction of revenues related to long-term project work, which during 2005 has diminished as a result of the Company focusing the business to more of a licensing model.

Fire Safety

The increase in these revenue components from 2004 is primarily attributable to the fact that the business was acquired in the third quarter of 2004. Therefore 2004 represents only one quarter of revenue, whereas 2005 reflects four quarters of revenue. This was compounded by a general increase in overall revenue that can be attributed to a strengthened market presence through concerted efforts toward penetrating new markets by actively pursuing and marketing our Fire Safety products. Additionally revenue growth can be also attributable to functionality that was added across the entire Fire Safety product suite as well as the release of new FireRMS mobile product which was released in the middle of 2005.

Biometrics

During 2004 and 2005 Biometric segment continues to show strong revenue growth year over year. This is reflective of continued market acceptance of the product and strategic channel relationships that have been developed. Additionally, the product has been a proven solution in the educational industry as well has shown continued commercial integration and acceptance of the product.

Costs of goods sold

Law Enforcement

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

Service costs increased primarily because of personnel related costs that have increased over the prior year primarily from the inclusion of a full year of costs as compared to only one quarter in 2004. This was offset by reductions related to a reduced concentration of project related revenues which are heavily burdened with labor costs, both employees and contracted labor. As significant project revenues declined after the first two quarters of 2005, this reduction offset the increase that would have occurred related to maintaining a full twelve months of expense.

Fire Safety

License and other costs are attributable primarily to revenues derived from product sales for which we are required to pay a royalty. The slight increase 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.

Services costs have increased over the prior year primarily from the inclusion of a full year of costs as compared to only one quarter as well as contractors and related costs that have been incurred related to project and service related revenues. There was a significant growth in service revenues for which additional outside contractors were used in providing some of those services.

Biometrics

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. During 2004 and 2003 the volume attributable to readers remained fairly constant whereas in 2005 volume decreased resulting in a reduction of related product cost.

Service cost has increased during 2005 related primarily to a higher percentage of revenue requiring software customization and integration costs as compared to 2004 and 2003.

Selling, general and administrative

	2005	2004 Restated	2003 Restated	2005 - 2004 $ Chg	% Chg	2004 - 2003 $ Chg	% Chg
Law Enforcement	$ 7,471,524	$ 3,047,247	$	$ 4,424,277	145 %	$ 3,047,247	n/a
Fire Safety	2,802,220	783,948		2,018,272	257 %	783,948	n/a
Biometrics	1,550,865	3,283,093	2,099,922	(1,732,228)	(53) %	1,183,171	56 %
Total	$ 11,824,609	$ 7,114,288	$ 2,099,922	$ 4,710,321	66 %	$ 5,014,366	238 %

SG&A costs increased during the year as a result of 2005 representing a full 12 months worth of expenses as compared to 2004 which included only 3 months of expenses of the Law and Fire segments. As noted above, these costs are allocated based on the Segment s percentage of revenue. Changes in SG&A costs between business segments are the result of the change in their respective percentage of BIO-key s total revenue.

During 2004 the increase in SG&A was primarily attributable to the acquisition of Mobile Government. The additional costs incurred were the result of legal and audit costs surrounding both the acquisition of Mobile Government as well as Public Safety Group. Additionally, the increase was due to an increased workforce in sales and administration functions as well as the associated overhead which results from fully loaded labor charges associated with supporting larger operations. This increase was offset slightly by the elimination of non essential functions done in order to align the business with its revised model of focusing sales through channel partners and creating a model focused on licensing as oppose to integration projects.

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Research, development and engineering

	2005	2004	2003	2005 - 2004 $ Chg	% Chg	2004 - 2003 $ Chg	% Chg
Law Enforcement	$ 3,931,265	$ 1,309,026	$	$ 2,622,239	200 %	$ 1,309,026	n/a
Fire Safety	1,207,263	337,310		869,953	258 %	337,310	n/a
Biometrics	1,707,507	1,333,568	1,037,330	373,939	28 %	296,238	29 %
Total	$ 6,846,035	$ 2,979,904	$ 1,037,330	$ 3,866,131	130 %	$ 1,942,574	187 %

Law Enforcement

R & D costs have increased over 2004 primarily related to the acquisition of Mobile Government in Q3 of 2004. During 2005 the Company spent significant R&D resources in sustaining engineering related to the large customer base as well as developing new version releases that incorporated these changes. While remaining focused on achieving these operational objectives the Company also undertook cost reduction initiatives which resulted in an approximately 25-30% reduction of the fourth quarter 2004 run rate for R&D costs in the Law Enforcement segment.

Fire Safety

R & D costs have increased over 2004 primarily related to the acquisition of Mobile Government in Q3 of 2004. Additionally, subsequent to the acquisition, the company had several engineering initiatives in the Fire segment. As noted above a number of product enhancements were made to functionality across the entire software suite in addition to focused development of the new FireRMS mobile solution delivered to the market mid 2005. While remaining focused on achieving these product objectives, in conjunction with the Company wide cost reduction initiatives, Fire Safety was able to realize an approximate reduction of 10% the fourth quarter 2004 run rate for R&D costs.

Biometrics

R & D costs have increased sequentially from 2003 to 2005. This is representative of the increased spending to enhance the interoperability and functionality of the software. The company continues to spend in R&D to enhance the products usability in different markets as well as to develop the product for integration with products from BIO-key s other segments. During 2005, BIO-key released IdentityMatch, a product which integrates BIO-key s advanced biometric offerings with BIO-key s mobile data and fire records management solutions. BIO-key continues to develop further integration of its Biometric software solutions in other products with in Company as well as partnering with other solutions in the marketplace. Additionally, in May of 2005 the Company was awarded a patent for its award-winning leadership Vector Segment fingerprint technology or Image Identification System.

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Other income and expense

	2005 Restated	2004 Restated	2003 Restated	2005 - 2004 $ Chg	% Chg	2004 - 2003 $ Chg	% Chg
Interest expense	$ (4,521,344)	$ (1,415,535)	$ (1,909,788)	$ (3,105,809)	219 %	$ 494,253	26 %
Interest income	35,958	66,824		(30,866)	(46) %	66,824	n/a
Gain on sale of marketable securities	(20,000)	33,125		(53,125)	(160) %	33,125	n/a
Non-cash interest income (expense)	9,154,951	(3,008,419)	857,545	12,163,370	(404) %	(3,865,964)	(451) %
Other income (expense)	(34,767)	(88,425)	4,145	53,658	(61) %	(92,570)	(2,233) %
	$ 4,614,798	$ (4,412,430)	$ (1,048,098)	$ 9,027,228	(205) %	$ (3,364,332)	321 %

For the year ended December 31, 2005, consolidated interest expense increased $3,105,809 or 219% as compared to 2004, which was attributable to the increase in long term debt from issuance of the 2004 and 2005 Senior and Subordinated notes. For the year ended December 31, 2004, consolidated interest expense increased $494,253 or 26% from 2003.

For the year ended December 31, 2005, consolidated interest income decreased $30,866 or 46% as compared to 2004, which was attributable to the average amount of cash held on hand in interest bearing accounts. For the year ended December 31, 2004, consolidated interest income increased $66,824 as compared to 2003, which was attributable to deposits held in interest bearing accounts in 2004. No deposits were held in interest bearing accounts in 2003.

For the year ended December 31, 2005, consolidated derivative and warrant fair value adjustments increased $12,163,370 or 404% as compared to 2004, which was attributable to changes in the fair market value of embedded derivatives and detachable warrants issued with convertible debt. The fair value of the derivatives will fluctuate based on; our stock price at particular points in time, the debt conversion price, the volatility of our stock price over a period of time, changes in the value of the risk free interest rate, and the time to maturity of the outstanding debt at different points in time. The major factor contributing to this change was due to the decline in the market price of our stock from $1.60 as of December 31, 2004 to $.69 as of December 31, 2005. For the year ended December 31, 2004, derivative and warrant fair value adjustments decreased $3,865,964 or 451% as compared to 2003, which was also attributable to changes in the fair value of embedded derivatives and detachable warrants issued with convertible debt. The major factor contributing to the large fluctuation in the fair value was due to the net increase in the market price of our stock from $1.03 as of September 29, 2004 to $1.60 as of December 31, 2004.

LIQUIDITY AND CAPITAL RESOURCES

OPERATING ACTIVITIES OVERVIEW

The net cash used in operating activities during 2005 was $4,513,497, as compared to $5,644,759 and $2,857,145 in 2004 and 2003, respectively. Some of the major drivers of this change are discussed in more detail below.

The Company s income statement includes four non-cash items which made the most significant contributions to the net cash used in operating activities in 2004 and 2005.

- The Company issued notes in 2004 and 2005 which contained embedded derivatives. In 2004, the company recorded a loss of approximately $3,008,419 related to the increase in value of the derivatives. The increase in value was caused by the increase in the value of the underlying BIO-key stock. In 2005, the company recorded a gain of approximately $9,154,951 related to the decrease in value of the derivatives. The decrease in value is the result of the decline in value of the underlying BIO-key stock.

- A debt discount was recorded when the notes were initially recorded to reflect the FMV of derivatives and warrants related to the debt. The discount is amortized ratably into earnings over the life of the related debt. In 2004 and 2005, the company recorded non-cash interest expense related to the amortization of the debt discount of approximately $757,318 and $2,097,973 respectively.

- The Company recorded a $55,150 and $664,043 charge in 2004 and 2005, respectively, for the non-cash expense of issuing options and warrants to non employees for services.

- Finally, the Company recorded $550,421 and $1,509,880 in 2004 and 2005, respectively, for the non-cash expense related to the amortization of intangibles assets.

For the year ended December 31, 2005, the Company reported positive cash flows related to a decrease in costs and earnings in excess of billings on uncompleted contracts of $2,468,770. 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. In 2005, the Company was able to bill the customer due to the fact that the milestones have been reached.

The Company experienced positive cash flows of $1,029,404 in 2005 due to increased accrued liabilities related to interest on the 2005 debt as well as contract related costs not being invoiced by vendors. In 2004, the Company experienced positive cash flows of $955,050 related to interest on the 2004 debt as well as liabilities assumed through acquisitions.

The Company also experienced a positive cash flow from an increase of $1,191,958 in deferred revenue from 2004 to 2005 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 are to be 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.

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 are to be 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 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.

Liquidity outlook

At December 31, 2005 our total of cash and cash equivalents was $1,422,827. The total was $956,230 and $1,012,790 at December 31, 2004 and 2003, respectively. We have financed ourselves through access to the capital markets by issuing debt securities, convertible preferred stock and common stock.

As of March 23, 2006, we had cash resources of approximately $1,830,000 and $11,277,000 of convertible debt as described in the Long-Term Obligations footnote of this report below. We currently require approximately $1,700,000 per month to conduct our operations. During the fourth quarter of 2005, we generated approximately $3,368,000 of revenue and expect to increase quarterly revenue in 2006.

The Company has undertaken strategic steps to position itself to realize positive cash flows from operations in the future by increasing revenues and better managing expenses. These steps include the acquisition of two enterprises in 2004. Although the acquisitions inherently produced a greater demand for cash than we would have liked, we are confident that many of the initial costs are isolated in nature and will not be recurring year after year. The Company has also taken strategic steps to downsize the workforce in areas that we felt were either non essential or not in line with where we wanted the Company to develop in the near future. The Company has also recently experienced additional costs associated with various compliance related activities.

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.

As of May 19, 2006, the Company was delinquent with respect to some interest obligations on certain subordinated notes issued in September 2004 and May 2005. Due to certain cross default provisions contained in both the senior and subordinated notes, all outstanding debt is considered to be in default. Accordingly, the Company has reclassified approximately $8,849,000 of principal from long-term to current liabilities as of March 31, 2006 and approximately $9,734,000 of principal from long-term to current liabilities as of December 31, 2005. All of the related discount and embedded derivatives associated with the debt has also been reclassed to current.

CONTRACTUAL OBLIGATIONS

We have various contractual obligations impacting our liquidity. The following represents some of our contractual obligations as of December 31, 2005:

	Total	**2006**	**2007**	**2008**	**2009**
Non-cancelable operating leases	$ 3,427,000	$ 1,260,000	$ 1,278,000	$ 866,000	$ 23,000
Senior secured convertible term notes	5,599,999	1,524,211	3,048,421	1,027,367	
Subordinated unsecured convertible term notes	5,677,028	18,750	14,063		5,644,215
Total	$ 14,704,027	$ 2,802,961	$ 4,340,484	$ 1,893,367	$ 5,667,215

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 2009. 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.

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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. Further, the Company recalculated the convertible preferred stock dividends and accretion including the accrued but unpaid dividends in accordance with FAS 128 *Earnings per Share*.

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*

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 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 and 2004 and our previously reported unaudited financial statements for the first, second and third quarters of 2003, 2004 and 2005 (the restatement). The restatement covers a number of separate matters, each of which is described above.

For the quarterly impact of the restatement and the restated financial results for the first, second and third quarters of 2003, 2004 and 2005 see Note X, Results by Quarter.

The following tables summarize the impact of all of these adjustments on previously reported revenue and assets, liabilities, and stockholders equity (deficit) for the years ended December 31, 2004 and 2003.

	Impact of Adjustments on Revenue For the Years Ended December 31, 2005	2004	2003
As previously reported	$ 14,226,095	$ 5,558,231	$ 524,101
Revenue recognition		162,720	(308,620)
As restated	$ 14,226,095	$ 5,720,951	$ 215,481

	Impact of Adjustments on Consolidated Balance Sheet Accounts As of December 31, 2005 Total Assets	Liabilities	Stockholders Equity (Deficit)
As previously reported	$ 26,357,934	$ 17,050,206	$ 9,307,728
Revenue recognition and related SG&A expense			
Debt financing		3,143,724	(3,143,724)
Total Adjustments		3,143,724	(3,143,724)
As restated	$ 26,357,934	$ 20,193,930	$ 6,164,004

	Impact of Adjustments on Consolidated Balance Sheet Accounts As of December 31, 2004			As of December 31, 2003		
	Total Assets	Liabilities	Stockholders Equity (Deficit)	Total Assets	Total Liabilities	Stockholders Equity (Deficit)
As previously reported	$ 30,844,681	$ 20,223,283	$ 10,621,398	$ 1,864,742	$ 11,000,731	$ (9,135,989)
Revenue recognition and related SG&A expense	(122,090)	23,810	(145,900)	(308,620)	(18,200)	(290,420)
Debt financing	816,501	4,742,344	(3,925,843)		(57,543)	57,543
Total Adjustments	694,411	4,766,154	(4,071,743)	(308,620)	(75,743)	(232,877)
As restated	$ 31,539,092	$ 24,989,437	$ 6,549,655	$ 1,556,122	$ 10,924,988	$ (9,368,866)

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The following tables present the effect of the restatement adjustments on the consolidated Statement of Operations for the years ended December 31, 2005, 2004 and 2003.

	Year Ended December 31, 2005 As Previously Reported	Effect of Restatement	As Restated
Revenues			
Services	$ 10,861,649	$	$ 10,861,649
License fees and other	3,364,446		3,364,446
	14,226,095		14,226,095
Costs and other expenses			
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
	22,514,277		22,514,277
Operating loss	(8,288,182)		(8,288,182)
Other income (deductions)			
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)
Total other income (deductions)	8,646,247	(4,031,449)	4,614,798
NET INCOME (LOSS)	$ 358,065	$ (4,031,449)	$ (3,673,384)
Basic Loss per Share:			
Numerator			
Net loss	$ 358,065	$ (4,031,449)	$ (3,673,384)
Convertible preferred stock dividends and accretion	(313,517)		(313,517)
Net Income (Loss) attributable to common shareholders	$ 44,548	$ (4,031,449)	$ (3,986,901)
Denominator			
Weighted average common shares outstanding	44,787,807	44,787,807	44,787,807
Basic Loss per Share	$ 0.00	$ (0.09)	$ (0.09)
Diluted Loss per Share:			
Numerator			
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)
Net loss attributable to common shareholders and assumed conversions	$ (8,751,286)	$ 2,727,440	$ (6,023,846)
Denominator			
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
Diluted Loss per Share	$ (0.17)	$ 0.05	$ (0.12)

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	Year Ended December 31, 2004 As Previously Reported	Effect of Restatement	As Restated
Revenues			
Services	$ 3,351,406	$	$ 3,351,406
License fees and other	2,206,825	162,720	2,369,545
	5,558,231	162,720	5,720,951
Costs and other expenses			
Services	1,174,324		1,174,324
Cost of license fees and other	889,896		889,896
Selling, general and administrative	7,096,088	18,200	7,114,288
Research, development and engineering	2,979,904		2,979,904
	12,140,212	18,200	12,158,412
Operating loss	(6,581,981)	144,520	(6,437,461)
Other income (deductions)			
Interest income	66,824		66,824
Interest expense	(667,008)	(748,527)	(1,415,535)
Derivative and warrant fair value adjustments		(3,008,419)	(3,008,419)
Other expense	(55,300)		(55,300)
Total other income (deductions)	(655,484)	(3,756,946)	(4,412,430)
NET LOSS	$ (7,237,465)	$ (3,612,426)	$ (10,849,891)
Basic Loss per Share:			
Numerator			
Net loss	$ (7,237,465)	$ (3,612,426)	$ (10,849,891)
Convertible preferred stock dividends and accretion	(414,240)	28,885	(385,355)
Net Loss attributable to common shareholders	$ (7,651,705)	$ (3,583,541)	$ (11,235,246)
Denominator			
Weighted average common shares outstanding	34,806,201	34,806,201	34,806,201
Basic Loss per Share	$ (0.22)	$ (0.10)	$ (0.32)
Diluted Loss per Share:			
Numerator			
Net loss attributable to common shareholders	$ (7,651,705)	$ (3,583,541)	$ (11,235,246)
Effect of Dilutive Securities: Convertible Debentures			
Net loss attributable to common shareholders and assumed conversions	$ (7,651,705)	$ (3,583,541)	$ (11,235,246)
Denominator			
Weighted average shares outstanding	34,806,201	34,806,201	34,806,201
Effect of Dilutive Securities: Convertible Debentures			
Diluted weighted average common shares and common equivalents outstanding	34,806,201	34,806,201	34,806,201
Diluted Loss per Share	$ (0.22)	$ (0.10)	$ (0.32)

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	Year Ended December 31, 2003 As Previously Reported	Effect of Restatement	As Restated
Revenues			
Services	$ 10,694	$	$ 10,694
License fees and other	513,407	(308,620)	204,787
	524,101	(308,620)	215,481
Costs and other expenses			
Cost of services	1,694		1,694
Cost of license fees and other	87,387		87,387
Selling, general and administrative	2,118,122	(18,200)	2,099,922
Research, development and engineering	1,037,330		1,037,330
	3,244,533	(18,200)	3,226,333
Operating loss	(2,720,432)	(290,420)	(3,010,852)
Other income (deductions)			
Interest expense	(1,109,786)	(800,002)	(1,909,788)
Derivative and warrant fair value adjustments		857,545	857,545
Other income	4,145		4,145
Total other income (deductions)	(1,105,641)	57,543	(1,048,098)
NET LOSS	$ (3,826,073)	$ (232,877)	$ (4,058,950)
Basic Loss per Share:			
Numerator			
Net loss	$ (3,826,073)	$ (232,877)	$ (4,058,950)
Convertible preferred stock dividends and accretion	(136,755)		(136,755)
Net loss attributable to common shareholders	$ (3,962,828)	$ (232,877)	$ (4,195,705)
Denominator			
Weighted average common shares outstanding	17,543,586	17,543,586	17,543,586
Basic Loss per Share	$ (0.23)	$ (0.01)	$ (0.24)
Diluted Loss per Share:			
Numerator			
Net loss attributable to common shareholders	$ (3,962,828)	$ (232,877)	$ (4,195,705)
Effect of Dilutive Securities: Convertible Debentures			
Net loss attributable to common shareholders and assumed conversions	$ (3,962,828)	$ (232,877)	$ (4,195,705)
Denominator			
Weighted average shares outstanding	17,543,586	17,543,586	17,543,586
Effect of Dilutive Securities: Convertible Debentures			
Diluted weighted average common shares and common equivalents outstanding	17,543,586	17,543,586	17,543,586
Diluted Loss per Share	$ (0.23)	$ (0.01)	$ (0.24)

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The following tables present the effect of the restatement adjustments on the Consolidated Balance Sheet as of December 31, 2005, 2004 and 2003.

CONSOLIDATED BALANCE SHEET

	As of December 31, 2005 As Previously Reported	Effect of Restatement	As Restated
ASSETS			
Cash and cash equivalents	$ 1,422,827	$	$ 1,422,827
Receivables			
Billed less allowance for doubtful receivables as of $160,000	1,635,371		1,635,371
Unbilled	201,942		201,942
Costs and earnings in excess of billings on uncompleted contracts	4,321,392		4,321,392
Inventory	8,760		8,760
Prepaid expenses	137,000		137,000
Total current assets	7,727,292		7,727,292
Equipment and leasehold improvements, net	548,267		548,267
Deposits	1,828,560		1,828,560
Intangible assets less accumulated amortization	3,301,823		3,301,823
Deferred financing costs, net	1,562,338		1,562,338
Goodwill	11,389,654		11,389,654
Total non-current assets	18,630,642		18,630,642
TOTAL ASSETS	$ 26,357,934	$	$ 26,357,934
LIABILITIES			
Current maturities of long-term obligations	$ 4,924,224	$ 3,143,724	$ 8,067,948
Accounts payable	833,608		833,608
Billing in excess of costs and earnings on uncompleted contracts	32,385		32,385
Accrued liabilities	5,520,515		5,520,515
Deferred rent	443,603		443,603
Deferred revenue	3,264,283		3,264,283
Total current liabilities	15,018,618	3,143,724	18,162,342
Long-term obligations, net of discount and current maturities			
Deferred rent	867,850		867,850
Deferred revenue	1,163,738		1,163,738
Total non-current liabilities	2,031,588		2,031,588
TOTAL LIABILITIES	17,050,206	3,143,724	20,193,930
STOCKHOLDERS EQUITY (DEFICIT)			
Preferred stock-authorized, 5,000,000 shares (liquidation preference of $100 per share) Series A 7% Convertible; issued and outstanding, 44,557shares of $.0001 par value	4		4
Common stock-authorized, 85,000,000 shares, 46,306,589 issued and outstanding of $.0001 par value	4,632		4,632
Additional paid-in capital	51,529,332	(2,608,016)	48,921,316
Accumulated deficit	(42,226,240)	(535,708)	(42,761,948)
TOTAL STOCKHOLDERS EQUITY (DEFICIT)	9,307,728	(3,143,724)	6,164,004
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)	$ 26,357,934	$	$ 26,357,934

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CONSOLIDATED BALANCE SHEET

	As of December 31, 2004 As Previously Reported	Effect of Restatement	As Restated
ASSETS			
Cash and cash equivalents	$ 956,230	$	$ 956,230
Marketable debt securities	1,000,000		1,000,000
Receivables			
Billed less allowance for doubtful receivables as of $422,393	1,698,144	(90,090)	1,608,054
Unbilled	310,523		310,523
Due from selling stockholders and other	60,793	(32,000)	28,793
Costs and earnings in excess of billings on uncompleted contracts	6,292,603		6,292,603
Inventory	29,599		29,599
Prepaid expenses	113,130		113,130
Total current assets	10,461,022	(122,090)	10,338,932
Equipment and leasehold improvements, net	644,101		644,101
Costs and earnings in excess of billings on uncompleted contracts	657,000		657,000
Deposits	2,838,031		2,838,031
Intangible assets less accumulated amortization	4,177,279	(77,982)	4,099,297
Deferred financing costs, net		938,118	938,118
Goodwill	12,067,248	(43,635)	12,023,613
Total non-current assets	20,383,659	816,501	21,200,160
TOTAL ASSETS	$ 30,844,681	$ 694,411	$ 31,539,092
LIABILITIES			
Current maturities of long-term obligations	$ 3,255,182	$ (192,460)	$ 3,062,722
Advances from stockholders	12,753		12,753
Accounts payable	1,325,282	23,810	1,349,092
Billing in excess of costs and earnings on uncompleted contracts	760,807		760,807
Accrued liabilities	4,639,619	(43,635)	4,595,984
Deferred rent	393,676		393,676
Deferred revenue	3,166,356		3,166,356
Total current liabilities	13,553,675	(212,285)	13,341,390
Long-term obligations, net of discount and current maturities	5,286,951	4,978,439	10,265,390
Deferred rent	1,311,454		1,311,454
Deferred revenue	71,203		71,203
Total non-current liabilities	6,669,608	4,978,439	11,648,047
TOTAL LIABILITIES	20,223,283	4,766,154	24,989,437
STOCKHOLDERS EQUITY (DEFICIT)			
Preferred stock-authorized, 5,000,000 shares (liquidation preference of $100 per share) Series C 7% Convertible; issued and outstanding, 62,182 shares of $.01 par value	623		623
Common stock-authorized, 85,000,000 shares, 40,680,691 issued and outstanding of $.01 par value	406,808		406,808
Additional paid-in capital	45,325,172	(226,441)	45,098,731
Accumulated deficit	(35,111,205)	(3,845,302)	(38,956,507)
TOTAL STOCKHOLDERS EQUITY (DEFICIT)	10,621,398	(4,071,743)	6,549,655
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)	$ 30,844,681	$ 694,411	$ 31,539,092

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CONSOLIDATED BALANCE SHEET

	As of December 31, 2003 As Previously Reported	Effect of Restatement	As Restated
ASSETS:			
Cash and cash equivalents	$ 1,012,790	$	$ 1,012,790
Receivables billed	409,803	(308,620)	101,183
Inventory	65,857		65,857
Prepaid expenses	165,929		165,929
Total current assets	1,654,379	(308,620)	1,345,759
Equipment and leasehold improvements, net	60,157		60,157
Intangible assets less accumulated amortization	68,306		68,306
Deferred financing costs, net	81,900		81,900
Total non-current assets	210,363		210,363
TOTAL ASSETS	$ 1,864,742	$ (308,620)	$ 1,556,122
LIABILITIES:			
Advances from stockholders	$ 34,030	$	$ 34,030
Accounts payable	351,742		351,742
Accrued liabilities	173,736	(18,200)	155,536
Deferred revenue	10,000		10,000
Total current liabilities	569,508	(18,200)	551,308
Long-term obligations, net of discount and current maturities	10,431,223	(57,543)	10,373,680
Total non-current liabilities	10,431,223	(57,543)	10,373,680
TOTAL LIABILITIES	11,000,731	(75,743)	10,924,988
STOCKHOLDERS EQUITY (DEFICIT)			
Preferred stock-authorized, 5,000,000 shares (liquidation preference of $100 per share) Series B 9% Convertible; issued and outstanding, 4,180 shares of $.01 par value	42		42
Common stock-authorized, 85,000,000 shares, issued and outstanding 21,222,990 of $.01 par value	212,229		212,229
Additional paid-in capital	18,327,992		18,327,992
Accumulated deficit	(27,676,252)	(232,877)	(27,909,129)
TOTAL STOCKHOLDERS EQUITY (DEFICIT)	(9,135,989)	(232,877)	(9,368,866)
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)	$ 1,864,742	$ (308,620)	$ 1,556,122

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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, usage fees and services or various combinations thereof. For each arrangement, revenues will be recognized when evidence of an agreement has been documented, the fees are fixed or determinable, collection of fees is probable, delivery of the product has occurred and no other significant obligations remain.

Multiple-Element Arrangements: For multiple-element arrangements, each element of the arrangement will be analyzed and the Company will allocate a portion of the total fee under the arrangement to the elements using vendor specific objective evidence of fair value of the element, regardless of any separate prices stated within the contract for each element. Vendor specific objective evidence is based on the price the customer is required to pay when the element is sold separately (i.e., software license fees charged when consulting or other services are not provided, hourly rates charged for consulting services when sold separately from a software license or usage fees). If vendor specific objective evidence of fair value does not exist for any undelivered elements, all revenue is deferred and recognized ratably over the service period if the undelivered element is services, or until sufficient objective evidence of fair value exists or all elements have been delivered.

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

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.

Usage Fees: Usage fees are charged on certain applications based on the customer s volume of use. Usage revenue is recognized based on the actual level of activity used by the customer or, in the case of fixed-fee arrangements, ratably over the arranged time period.

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

We have completed our acquisitions of PSG and AMG. These acquisitions have been accounted for under the purchase method of accounting, which has resulted in recording significant goodwill and other intangible asset balances. The purchase prices have been allocated to

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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. Our accounting for these 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. The developed technology (software), copyrighted software, marketing agreements, customer relationships and trademarks were valued using the income approach and are being amortized on a straight line basis over their estimated useful lives, which range from 5 to 7 years.

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. On December 31, 2004, the Company s investments were all classified as available-for-sale. In January 2005 the Company sold these investments and did not purchase any additional Marketable Debt Securities as of December 31, 2005.

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 (SFAS) No. 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 30th of each year using a number of criteria, including the value of the overall enterprise. As of December 31, 2005, 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 is expensed as incurred.

9. *Earnings Per Share Common Stock*

Earnings per share of common stock-basic is computed by dividing Net Income applicable to common stockholders by the weighted-average number of common shares outstanding for the period. Earnings per share of common stock-assuming dilution reflects the maximum potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock and would then share in the net income of the company. See note U Earnings Per Share of Common Stock, 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 carry back, carry forward 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 carry forward 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*

The Company s employee stock compensation plans are accounted for in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations. Under this method, no compensation expense is recognized as long as the exercise price equals or exceeds the market price of the underlying stock on the date of the grant. The Company elected the disclosure-only alternative permitted under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (FAS 123), as amended by FAS 148, for fixed stock-based awards to employees. All non-employee stock-based awards are accounted for at fair value and recorded as compensation expense over the period of service in accordance with FAS 123 and related interpretations.

On December 31, 2005, the Company accelerated the vesting of certain of the outstanding options to purchase shares of the Company s common stock with option exercise prices greater than the fair market value of the Company s common stock on such date. The acceleration applies to all such options outstanding as of December 31, 2005 under the Company s 1996 Stock Option Plan, 1999 Stock Option Plan and 2004 Stock Option Plan, except for options held by the Company s executive officers subject to Section 16(b) of the Securities Exchange Act of 1934, as amended, and the members of the Company s Board of Directors. Options to purchase up to 897,614 shares of the Company s common stock, or 14% of the total shares of the Company s common stock subject to outstanding options, with a weighted average exercise price of approximately $1.09 and varying remaining vesting schedules, are subject to this acceleration and become immediately vested and exercisable as of December 31, 2005. The number of shares, exercise prices and other terms of the options subject to the acceleration remain unchanged.

As a result of this acceleration, the Company expects to reduce its exposure to the effects of the Financial Accounting Standards Board s Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123R), which requires companies to recognize stock-based compensation expense associated with stock options based on the fair value method. The Company currently expects a reduction in stock-based compensation expense associated with this acceleration of approximately $330,000 for fiscal year 2006 and approximately $225,000 for fiscal year 2007.

In December 2002, the Financial Accounting Standards Board (FASB) issued SFASB No.148, Accounting for Stock-Based Compensation-Transition and Disclosure. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary charge to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 149 requires expanded more prominent disclosure in both annual and interim financial statements about the method of stock-based employee compensation and the effect of the method on reported results.

The Company has not adopted a method under SFAS No. 148 to expense stock options but rather continues to apply the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock issued to Employees, and related interpretations in accounting for those plans. No stock-based employee compensation expense for options is reflected in net income or loss for the fiscal periods presented as all options granted under those plans had an exercise price equal to or lower than the market price of the underlying common stock at the date of grant.

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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 preferred stock, and stock options, discounts, embedded derivatives, and warrants outstanding.

OTHER MATTERS

Not Applicable

RECENT ACCOUNTING STANDARDS

In November 2005, FASB issued FSP FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP FAS 115-1 also includes accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP FAS 115-1 is required to be applied to reporting periods beginning after December 15, 2005. We are required to adopt FSP FAS 115-1 in the first quarter of fiscal 2006. We do not expect that the adoption of the statement will have a material impact on our consolidated results or financial condition.

In May 2005, FASB issued SFAS 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 . SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle, and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. We do not expect that adoption of this statement will have a material impact on our results of operations or financial condition.

In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations an interpretation of FASB Statement No. 143* (FIN 47), which requires companies to recognize a liability for the fair value of a legal obligation to perform asset retirement activities that are conditional on a future event if the amount can be reasonably estimated. We adopted the provisions of FIN 47 on December 31, 2005. No conditional asset retirement obligations were recognized and, accordingly, the adoption of FIN 47 had no effect on our financial statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). This statement replaces SFAS No. 123 and supersedes *APB Opinion No. 25, Accounting for Stock Issued to Employees.* SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair value. The pro-forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. For the Company, SFAS 123R is effective for periods beginning after December 15, 2005. We plan to adopt SFAS 123R on January 1, 2006 using the modified prospective application method described in the statement. Under the modified prospective application method, we will apply the standard to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the unvested portion of awards outstanding as of the required effective date will be recognized as compensation expense as the requisite service is rendered after the required effective date. We are evaluating the impact of adopting SFAS 123R and expect that we will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on our cash flows but is expected to have a significant adverse effect on our results of operations. The future impact of the adoption of SFAS 123R cannot be predicted at this time because it will depend upon the levels of share-based payments granted in the future. However, had we adopted SFAS 123R in prior periods, the impact would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net loss attributable to common stockholders included in the Stock-Based Compensation footnote.

In November 2004, the FASB issued Statement No. 151, *Inventory Costs an amendment of ARB No. 43, Chapter 4*, which amends and clarifies existing accounting literature regarding abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). This statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with earlier application permitted. The provisions of this statement are to be applied prospectively. The adoption of this standard is not expected to have a material effect on the Company s financial position, results of operations, or liquidity.

ITEM 7. FINANCIAL STATEMENTS

See financial statements appearing at pages 50-139 of this report

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 8A. CONTROLS AND PROCEDURES

Remediation of Previously Reported Material Weaknesses in Internal Control over Financial Reporting

An evaluation of the effectiveness of the Company s disclosure controls and procedures (as such term is defined in Rules 13(a)-15(e) or 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of December 31, 2005 was carried out by the Company under the supervision and with the participation of the Company s Co-Chief Executive Officers (Co-CEOs) and Chief Financial Officer (CFO). As previously described in our Quarterly Reports on Form 10-QSB for the periods ended March 31, 2005, June 30, 2005 and September 30, 2005, we noted that our independent auditors, DS&B, Ltd., in a letter to the Audit Committee of the Company s Board of Directors dated April 18, 2005, had identified material weaknesses in the Company s internal control systems.

In order to ensure that the Company adequately addresses all existing internal control issues, the Company initiated follow-up discussions with its auditors to better determine what constituted these material weaknesses. During these discussions, the auditors and the Company identified the following 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 processes around drafting of periodic filings with the Securities and Exchange Commission.

During the fiscal quarter ended December 31, 2005, we have implemented changes that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. These measures include the following:

- <u>Inadequate System to capture Disclosure Items</u>

- The Company retained the services of a consulting firm that specializes in handling complex accounting issues to assist with its SB-2 registration statement and the responses to the SEC Staff s comments related to that registration statement and its periodic filings.

- The Company replaced its Assistant Controller with a Corporate Controller. This individual is a Certified Public Accountant with over ten years of experience.

- The Company hired a Manager of Accounting Operations with four years of public accounting experience.

- <u>Inadequate Internal Process of Review for Account Reconciliations</u>

- The Company instituted a more formal general ledger close process. Reconciliations for all balance sheet accounts are now prepared by the Company s accounting staff and then reviewed by either the Manager of Accounting Operations or the Corporate Controller prior to the preparation of the financial statements.

Other than the foregoing remedial measures, which the Company believes have, and will continue to, materially improve its internal control over financial reporting, there were no changes in the Company s internal control over financial reporting that occurred during the fiscal quarter ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting. From January 1, 2006 through the date of this Report, we have continued to implement additional changes that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. These measures include the following:

- <u>Inadequate System to capture Disclosure Items</u>

- In March 2006, the Company hired a Manager of Reporting who is a Certified Public Accountant with eighteen years of experience.

- <u>Inadequate Documentation of Internal Controls</u>

- The Company is in the process of identifying, analyzing and documenting the internal controls that it believes are critical to ensuring the accuracy of the transactions that are being recorded in the Company s accounting system. Some of the areas that are currently being documented include the revenue cycle, the disbursement cycle and equity transactions.

- <u>Inadequate Internal Process Around Drafting of periodic filings with the Securities and Exchange Commission</u>

- As part of the drafting of this Report, the Company s Audit Committee increased its oversight of the disclosure and reporting processes.

- In preparing this Report, the Company utilized a more formal disclosure checklist to ensure accuracy.

As noted above, the Company has identified four areas of material weakness in its internal control systems. While significant progress has been made to date to correct these weaknesses, we believe that all four areas still constitute material weaknesses. Based upon their evaluation of these conditions, the Company s Co-CEOs and CFO concluded that, as of December 31, 2005, the Company s disclosure controls and procedures were not effective to provide reasonable assurance that information the Company is required to disclose in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

Most of the process improvements detailed above were initiated during the fourth quarter of 2005 and several of our key financial personnel were also hired during that period. The Company intends to continue to implement changes to its internal control system during the remainder of 2006 to remediate the material weaknesses that have been identified. In particular, we will continue to make additions to our finance organization and related processes in an effort to further strengthen our internal controls. We will continue to retain the services of outside consultants to assist us with accounting for complex, non-routine transactions such as the financing transactions which we have completed during the prior two years. We will also continue to formalize our internal procedures to assure that all complex, non-routine transactions, as well as all aspects of our periodic filings, are reviewed by senior management and other accounting personnel with sufficient technical accounting expertise to evaluate and document such transactions and to provide related disclosure in our periodic filings. The Company believes that it will take two to three quarters from the date of this Report before the full benefit of all of these remedial measures will be realized.

Evaluation of Disclosure Controls and Procedures as of December 31, 2005

An evaluation of the effectiveness of the Company s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of December 31, 2005,was carried out by the Company under the supervision and with the participation of the Company s Co-Chief Executive Officers (Co-CEOs) and Chief Financial Officer (CFO).

As noted above, the Company has identified four areas of material weakness in its internal controls systems. While significant progress was made in 2005 to correct these weaknesses, we believe that all four areas still constitute material weaknesses. Based upon their evaluation of these conditions, the Company s CO-CEOs and CFO concluded that, as of December 31, 2005, the Company s disclosure controls and procedures were not effective to provide reasonable assurance that information the Company is required to disclose in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

The Company intends to continue to implement changes to its internal control system in 2006 to remediate the material weaknesses that have previously been identified. Also, we will continue to make additions to our finance organization and related processes in an effort to strengthen our internal controls.

ITEM 8B. OTHER INFORMATION

Not applicable.

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PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

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

NAME	AGE	POSITIONS HELD
Thomas J. Colatosti	58	Co-Chief Executive Officer, Chairman of the Board of Directors
Michael W. DePasquale	51	Co-Chief Executive Officer and Director
Jeffrey J. May	46	Director
Charles P. Romeo(a)	64	Director
John Schoenherr	53	Director
Francis J. Cusick	51	Chief Financial Officer
Randy Fodero	47	Vice President of Sales
Kenneth S. Souza	51	General Manager, Law Enforcement and Chief Technology Officer

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

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 has served as Co-Chief Executive Officer since July 2005. 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 20-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 has served as Co-Chief Executive Officer since July 2005. 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 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. 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 FreeedomBridge, 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 serves as Vice President of Corporate Performance Management for Oracle Corporation, and has served as an Oracle Vice President for over five years. Mr. Schoenherr has over 25 years of experience in the area of business intelligence. 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. Between November 1999 and December 2000, Mr. Cusick served as Corporate Controller for Equipe Communications Corporation and was responsible for all accounting and finance functions. Prior to Equipe, Mr. Cusick held senior financial management positions at 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 from 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 Chief Technology Officer of the Company since October 4, 2004 and the General Manager, Law Enforcement since October 18, 2005. 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. 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.

Board of Directors and Audit Committee Financial Expert

All directors hold office until the next annual meeting of shareholders and the election and qualification of their successors. Officers are elected annually by the Board of Directors and serve at the discretion of the Board.

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

Directors Compensation

Directors who are also officers of the Company receive no additional compensation for serving on the Board of Directors, other than reimbursement of reasonable expenses incurred in attending meetings. The Company s 1996 stock incentive plan provides for the grant of options to purchase 50,000 shares of common stock to each non-employee director upon first being elected or appointed to the Board of Directors. The Company s current policy is to issue options to purchase 50,000 shares of common stock to each non-employee director on an annual basis.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the U.S. Securities and Exchange Act of 1934, as amended (the Exchange Act), requires the Company s officers and directors and persons who own more than ten percent (10%) of the Company s Common Stock to file with the Securities and Exchange Commission (SEC) initial reports of ownership and reports of changes in ownership of the Company s Common Stock. Such officers, directors and ten percent (10%) stockholders are also required by applicable SEC rules to furnish the Company with copies of all forms filed with the SEC pursuant to Section 16(a) of the Exchange Act. Based solely on its review of the copies of such forms received by it, or written representations from such persons that no other reports were required for such persons, the Company believes that during the fiscal year ended December 31, 2005, all Section 16(a) filing requirements applicable to the Company s officers, directors and ten percent (10%) stockholders were satisfied in a timely fashion.

ITEM 10. EXECUTIVE COMPENSATION

The following table sets forth a summary of the compensation paid to or accrued by our chief executive officer and all of our other executive officers as of December 31, 2005 (the named executive officers) for each of the fiscal years ended December 31, 2003, 2004 and 2005:

SUMMARY COMPENSATION TABLE

	Annual Compensation					**Long Term Compensation**		
							Payouts	
						Awards		
	Fiscal Year	**Salary ($)**	**Bonus ($)**	**Other Annual Compensation ($)**	**Restricted Stock Award**	**Securities Underlying Options/SARs**	**LTIP Payouts**	**All Other**
Michael W. DePasquale (1)	2005	250,000						
Chief Executive Officer	2004	210,000	35,000					
	2003	148,943	25,000			1,080,000		
Francis J. Cusick (2)	2005	168,333				155,000		
Chief Financial Officer	2004	36,196				45,000		
	2003							
Randy Fodero (3)	2005	237,681 (4)				600,000		
Vice President Sales	2004	197,674						
	2003	125,986	10,000			600,000 (5)		
Kenneth S. Souza (6)	2005	200,000						
General Manager, Law Enforcement and Chief Technology Officer	2004	50,000	19,000			300,000		
	2003							

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

(2) Mr. Cusick became our Chief Financial Officer on February 28, 2005.

(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 $48,176, $47,674 and $10,282 of commission income in 2005, 2004 and 2003, respectively.

(5) These options expired unexercised on October 20, 2005.

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

OPTION GRANTS IN YEAR ENDED DECEMBER 31, 2005

The following table sets forth all options granted during the year ended December 31, 2005 to each of the named executive officers.

Name	Number of Securities Underlying Options Granted	Percent of Total Options Granted to Employees in Fiscal Year	Exercise Price $ /Share	Expiration Date
Francis J. Cusick (1)	155,000	10.0 %	$ 1.33	02/27/2012
Randy Fodero	600,000	38.7 %	0.60	11/10/2012

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(1) Options vested in three (3) annual installments commencing February 28, 2006.

(2) Options vest 33.3% upon grant and thereafter at 22.2222% in three (3) annual installments commencing November 11, 2006.

AGGREGATED OPTION EXERCISES IN THE YEAR ENDED DECEMBER 31, 2005 AND FISCAL YEAR-END OPTION VALUE

The following table sets forth for each named executive officer, information regarding stock options exercised by such officer during the year ended December 31, 2005, together with the number and value of stock options held at December 31, 2005, each on an aggregated basis.

Name	Number Of Shares Acquired On Exercise	Value Realized	Number Of Unexercised Options At Fiscal Year-End Exercisable/ Unexercisable(#)	Value Of Unexercised In-The-Money Options At Fiscal Year-End Exercisable/ Unexercisable($)(1)
Michael W. DePasquale			1,080,000	92,800/0
Francis J. Cusick				