SCM MICROSYSTEMS INC
Form 10-Q
November 14, 2006

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

**FORM 10 Q**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006**

**OR**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**FOR THE TRANSITION PERIOD FROM _________ TO _________**

**COMMISSION FILE NUMBER: 0-29440**

**SCM MICROSYSTEMS, INC.**
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| **DELAWARE** | **77-0444317** |
|---|---|
| (STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION) | (I.R.S. EMPLOYER IDENTIFICATION NUMBER) |

**41740 Christy Street, Fremont, CA 94538**
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES INCLUDING ZIP CODE)
**(510) 360-2300**
(REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE)
**466 Kato Terrace, Fremont, CA 94539**
(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

Yes o No þ

At November 7, 2006, 15,693,932 shares of common stock were outstanding.

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**PART I. FINANCIAL INFORMATION**
**Item 1. Financial Statements**

**SCM MICROSYSTEMS, INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
***(In thousands, except per share data)***
***(unaudited)***

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Net revenue | $ 7,396 | $ 8,051 | $ 24,185 | $ 20,534 |
| Cost of revenue | 5,271 | 4,948 | 16,251 | 12,501 |
| Gross profit | 2,125 | 3,103 | 7,934 | 8,033 |
| Operating expenses: | | | | |
| Research and development | 1,085 | 1,048 | 3,115 | 2,947 |
| Selling and marketing | 2,292 | 1,609 | 6,053 | 5,282 |
| General and administrative | 2,208 | 2,492 | 6,340 | 6,958 |
| Amortization of intangible assets | 170 | 163 | 495 | 513 |
| Restructuring and other charges | 400 | 22 | 1,066 | 174 |
| Total operating expenses | 6,155 | 5,334 | 17,069 | 15,874 |
| Loss from operations | (4,030) | (2,231) | (9,135) | (7,841) |
| Interest and other income | 367 | 416 | 809 | 2,029 |
| Loss from continuing operations before income taxes | (3,663) | (1,815) | (8,326) | (5,812) |
| Provision for income taxes | (17) | (135) | (46) | (128) |
| Loss from continuing operations | (3,680) | (1,950) | (8,372) | (5,940) |
| Income (loss) from discontinued operations, net of income taxes | (213) | (8) | 2,793 | (2,604) |
| Gain (loss) on sale of discontinued operations, net of income taxes | 24 | (89) | 5,287 | (74) |
| Net loss | $ (3,869) | $ (2,047) | $ (292) | $ (8,618) |
| Loss per share from continuing operations: | | | | |
| Basic and diluted | $ (0.24) | $ (0.12) | $ (0.54) | $ (0.39) |
| Gain (loss) per share from discontinued operations: | | | | |

| | | | | |
|---|---|---|---|---|
| Basic | $ (0.01) | $ (0.01) | $ 0.52 | $ (0.17) |
| Diluted | $ (0.01) | $ (0.01) | $ 0.52 | $ (0.17) |
| Net loss per share: | | | | |
| Basic | $ (0.25) | $ (0.13) | $ (0.02) | $ (0.56) |
| Diluted | $ (0.25) | $ (0.13) | $ (0.02) | $ (0.56) |
| Shares used to compute basic loss per share | 15,648 | 15,542 | 15,623 | 15,517 |
| Shares used to compute diluted loss per share | 15,648 | 15,542 | 15,646 | 15,517 |
| Comprehensive loss: | | | | |
| Net loss | $ (3,869) | $ (2,047) | $ (292) | $ (8,618) |
| Unrealized gain (loss) on investments | 32 | (59) | 61 | 150 |
| Foreign currency translation adjustment | 75 | (81) | 272 | (1,958) |
| Total comprehensive gain (loss) | $ (3,762) | $ (2,187) | $ 41 | $ (10,426) |

See notes to condensed consolidated financial statements.

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**SCM MICROSYSTEMS, INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
***(in thousands, except par value)***
***(unaudited)***

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 28,961 | $ 13,660 |
| Short-term investments | 7,316 | 18,780 |
| Restricted short-term investments (see Note 10) | 2,000 | |
| Accounts receivable, net of allowances of $1.088 and $972 as of September 30, 2006 and December 31, 2005, respectively | 4,344 | 6,904 |
| Inventories | 2,226 | 6,005 |
| Other current assets | 2,808 | 2,038 |
| Total current assets | 47,655 | 47,387 |
| Property and equipment, net | 1,466 | 3,050 |
| Intangible assets, net | 432 | 879 |
| Other assets | 1,882 | 1,418 |
| Total assets | $ 51,435 | $ 52,734 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 4,959 | $ 5,700 |
| Accrued compensation and related benefits | 1,705 | 2,708 |
| Accrued restructuring and other charges | 3,600 | 3,897 |
| Accrued professional fees | 1,524 | 1,644 |
| Accrued royalties | 1,029 | 1,244 |
| Other accrued expenses | 2,710 | 2,565 |
| Income taxes payable | 2,479 | 2,258 |
| Total current liabilities | 18,006 | 20,016 |
| Deferred tax liability | 100 | 101 |

| | | | | |
|---|---|---|---|---|
| Commitments and contingencies (see Notes 10 and 12) | | | | |
| Total liabilities | | 18,106 | | 20,117 |
| Stockholders equity: | | | | |
| Common stock, $0.001 par value: 40,000 shares authorized; 15,663 and 15,593 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively | | 16 | | 16 |
| Additional paid-in capital | | 228,347 | | 227,676 |
| Treasury stock | | (2,777) | | (2,777) |
| Accumulated deficit | | (193,048) | | (192,756) |
| Other cumulative comprehensive gain | | 791 | | 458 |
| Total stockholders equity | | 33,329 | | 32,617 |
| Total liabilities and stockholders equity | $ | 51,435 | $ | 52,734 |

See notes to condensed consolidated financial statements.

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**SCM MICROSYSTEMS, INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands)**
**(unaudited)**

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2006** | **2005** |
| Cash flows from operating activities: | | |
| Net income (loss) | $ (292) | $ (8,618) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Loss (gain) from discontinued operations | (8,080) | 2,678 |
| Depreciation and amortization | 795 | 1,396 |
| Loss (gain) on disposal of fixed assets | 46 | |
| Stock compensation expense | 485 | |
| Deferred income taxes | (1) | (20) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (216) | 1,896 |
| Inventories | 64 | (21) |
| Other assets | (910) | 85 |
| Accounts payable | 361 | 1,018 |
| Accrued expenses | (3,548) | (4,863) |
| Income taxes payable | 218 | 129 |
| Net cash used in operating activities from continuing operations | (11,078) | (6,320) |
| Net cash provided by (used in) operating activities from discontinued operations | 13,074 | (2,828) |
| Net cash provided by (used in) operating activities | 1,996 | (9,148) |
| Cash flows from investing activities: | | |
| Capital expenditures | (65) | (57) |
| Proceeds from disposal of fixed assets | 11 | 76 |
| Maturities of short-term investments | 14,392 | 6,768 |
| Purchase of restricted short-term investments | (2,000) | |
| Purchases of short-term investments | (2,878) | (12,399) |
| Net cash provided by (used in) investing activities from continuing operations | 9,460 | (5,612) |
| Net cash provided by (used in) investing activities from discontinued operations | 3,484 | (6) |
| Net cash provided by (used in) investing activities | 12,944 | (5,618) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of equity securities, net | 174 | 158 |
| Net cash provided by financing activities | 174 | 158 |

| | | |
|---|---|---|
| Effect of exchange rates on cash and cash equivalents | 187 | (1,350) |
| Net increase (decrease) in cash and cash equivalents | 15,301 | (15,958) |
| Cash and cash equivalents at beginning of period | 13,660 | 31,181 |
| Cash and cash equivalents at end of period | $ 28,961 | $ 15,223 |
| Supplemental disclosures of cash flow information: | | |
| Income tax refunds received | $ | $ |
| Income taxes paid | $ 106 | $ 34 |

See notes to condensed consolidated financial statements.

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**SCM MICROSYSTEMS, INC. AND SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**SEPTEMBER 30, 2006**

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulations S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the financial statements and footnotes thereto included in SCM Microsystems ( SCM or the Company ) Annual Report on Form 10-K for the year ended December 31, 2005.

*Discontinued Operations*

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its Digital Television solutions ( DTV solutions ) business to Kudelski S.A. ( Kudelski ) for total consideration of $11 million in cash, of which $9 million has been paid. Based on recent actions by Kudelski and the terms of the purchase agreement, the Company has made demand for payment of the remaining $2 million. The obligation to make the additional $2 million payment is disputed by Kudelski. Accordingly, the Company has not recorded the $2 million as receivable. In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144 ( SFAS 144 ), *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and nine months ended September 30, 2006 and 2005, this business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation. See Note 3 for further discussion of this transaction.

*Stock-based Compensation*

During the first quarter of fiscal 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, the Financial Accounting Standards Board s ( FASB ) SFAS No. 123 revised 2004 ( SFAS 123(R) ), *Share-Based Payment,* which replaced SFAS No. 123 ( SFAS 123 ), *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 ( APB 25 ), *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The Company elected to use the modified-prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123(R) apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The adoption of SFAS 123(R) did not have a material impact on the Company s consolidated financial position, results of operations and cash flows. See Note 2 for further information regarding the Company s stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had recorded stock-based compensation expense in accordance with SFAS 123.

*Recent Accounting Pronouncements*

In April 2006, the FASB issued FASB Staff Position No. FIN 46(R)-6 ( FSP FIN 46(R)-6 ), which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, as amended ( FIN 46(R) ). The variability that is considered in applying FIN 46(R) affects the determination of (a) whether the entity is a variable interest entity, (b) which interests are variable interests in the entity and (c) which party, if any, is the primary beneficiary of the variable interest entity. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary. FSP FIN 46(R)-6 provides additional guidance to consider for determining variability. FSP FIN 46(R)-6 is effective beginning the first day of the first reporting period beginning after June 15, 2006. After evaluating FSP FIN

46(R)-6, the Company determined that there is no impact to its consolidated financial position, results of operations or cash flows from its adoption.

In July 2006, the FASB issued FASB Interpretation No. 48 *Accounting for Uncertain Tax Positions* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109 *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 to its financial position and results of operations.

In June 2006, the Financial Accounting Standards Board, or FASB, ratified Emerging Issues Task Force, or EITF, Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* ( Issue No. 06-03 ). Under Issue No. 06-03, a company must disclose its accounting policy regarding the gross or net presentation of certain taxes. If taxes included in gross revenues are significant, a company must disclose the amount of such taxes for each period for which an income statement is presented (i.e., both interim and annual periods). Taxes within the scope of this Issue are those that are imposed on and concurrent with a specific revenue-producing transaction. Taxes assessed on an entity s activities over a period of time, such as gross receipts taxes, are not within the scope of the issue. Issue No. 06-03 is effective for the first annual or interim reporting period beginning after December 15, 2006. The Company is currently evaluating the impact of EITF, Issue No. 06-03 to its financial position and results of operations.

In September 2006, the Securities and Exchange Commission ( SEC ) published Staff Accounting Bulletin ( SAB ) No 108. SAB 108 expresses the staff views regarding the process of quantifying financial statement misstatements. The bulletin prescribes the use of rollover and iron curtain approaches in quantifying misstatements. Rollover approach quantifies a misstatement based on the amount of the error originating in the current year income statement. Iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the year, irrespective of the misstatement s year(s) of origination. The statement is effective immediately. The Company did not have any misstatements that were determined to be material on the basis of either of the approaches mentioned above.

**2. Stock Based Compensation**

The Company has a stock-based compensation program that provides its Board of Directors discretion in creating employee equity incentives. This program includes incentive and non-statutory stock options under various plans, the majority of which are stockholder approved. Stock options are generally time-based, vesting 25% each year over four years and expire ten years from the grant date. Additionally, the Company has an Employee Stock Purchase Plan ( ESPP ) that allows employees to purchase shares of common stock at 85% of the fair market value at the lower of either the date of enrollment or the date of purchase. Shares issued as a result of stock option exercises and the ESPP are newly issued shares. As of September 30, 2006, the Company had approximately 3.7 million shares of common stock reserved for future issuance under the stock option plans and ESPP.

On January 1, 2006, the Company adopted the provision of SFAS 123(R) for its share-based compensation plans. Under SFAS 123(R), the Company is required to recognize stock-based compensation costs based on the estimated fair value at the grant date for its share-based awards. In accordance to this standard, the Company recognizes the compensation cost of all share-based awards on a straight-line basis over the requisite service period which is the vesting period of the award.

The Company previously accounted for its employee stock option and employee stock purchase plans under the intrinsic value recognition and measurement principles of APB 25 and related Interpretations, and adopted the disclosure-only provisions of SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*. The pro forma effects on net loss and loss per share for stock options and ESPP awards were disclosed in a footnote to the unaudited condensed consolidated financial statements.

The Company has elected to use the modified prospective transition method as permitted by SFAS 123(R) and therefore has not restated its financial results for prior periods. Under this transition method, in the three and nine months ended September 30, 2006, the compensation cost recognized includes the cost for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value

estimated in accordance with the original provisions of SFAS 123. Compensation cost for all share-based compensation awards granted on or subsequent to January 1, 2006 was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation to expense from the accelerated multiple-option approach to the straight-line single option method. Compensation expense for all share-based payment awards granted

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prior to January 1, 2006 will continue to be recognized using the accelerated multiple-option approach while compensation expense for all share-based payment awards granted on or subsequent to January 1, 2006 has been and will continue to be recognized using the straight-line single-option approach.

Compensation expense recognized in the unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2006 is based on awards ultimately expected to vest and reflects estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to adoption of SFAS 123(R) the Company accounted for forfeitures as they occurred.

In calculating the compensation cost, the Company estimates the fair value of each option grant on the date of grant using the Black-Scholes-Merton options pricing model. The Black-Scholes-Merton option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, the Black-Scholes-Merton model requires the input of highly subjective assumptions including the expected stock price volatility.

As a result of adopting SFAS 123(R), the Company s loss from continuing operations before the income tax provision and net loss from discontinued operations for the three and nine months ended September 30, 2006 were $0.1 million and $0.5 million higher, respectively, than they would have been had the Company continued to account for share-based compensation under APB 25. Basic and diluted net loss per share from continuing operations for the three and nine months ended September 30, 2006 would have been $0.01 and $0.03 lower, respectively, if the Company had not adopted SFAS 123(R). There was no effect on the condensed consolidated statements of cash flows for the nine months ended September 30, 2006 from adopting SFAS 123(R).

The following table illustrates the stock-based compensation expense resulting from stock options and ESPP included in the unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2006 (in thousands):

| | **Three months Ended September 30, 2006** | **Nine months Ended September 30, 2006** |
|---|---|---|
| Cost of revenue | $ 10 | $ 24 |
| Research and development | 29 | 92 |
| Selling and marketing | 38 | 119 |
| General and administrative | 66 | 250 |
| Stock-based compensation expense before income taxes | $ 143 | $ 485 |
| Income tax benefit | | |
| Stock-based compensation expense after income taxes | $ 143 | $ 485 |

The following table illustrates the effect on reported net loss and net loss per share for the three and nine months ended September 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation (in thousands, except per share data):

| | **Three months Ended September 30, 2005** | **Nine months Ended September 30, 2005** |
|---|---|---|
| Net loss as reported | $ (2,047) | $ (8,618) |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects | | |

| | | | | |
|---|---|---|---|---|
| Less: Stock-based compensation expense determined under fair value method for all awards | | (333) | | (1,172) |
| Pro forma net loss | $ | (2,380) | $ | (9,790) |
| Net loss per share, as reported basic and diluted | $ | (0.13) | $ | (0.56) |
| Pro forma loss per share basic and diluted | $ | (0.15) | $ | (0.63) |

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***Stock Option Plans***

A total of 3,344,674 shares of common stock are currently reserved for future grant under the Plans.

Summary of activity under stock option plans for the nine months ended September 30, 2006 is as follows:

| | Options Available for Grant | Number of Options Outstanding | Weighted Average Exercise Price per share | Aggregate Intrinsic Value | Average Remaining Contractual Life (in years) |
|---|---|---|---|---|---|
| Balance at December 31, 2005 | 3,036,308 | 2,822,761 | $ 16.26 | | 6.07 |
| Options granted | (288,384) | 288,384 | $ 3.24 | | |
| Options cancelled or expired | 596,750 | (596,750) | $ 6.90 | | |
| Options exercised | | (21,130) | $ 2.78 | $ 7,293 | |
| Balance at September 30, 2006 | 3,344,674 | 2,493,265 | $ 17.11 | $ 207,176 | 5.37 |
| Vested or expected to vest at September 30, 2006 | | 2,360,452 | $ 17.89 | $ 171,948 | |
| Exerciseable at September 30, 2006 | | 1,973,504 | $ 20.76 | $ 98,325 | 4.45 |

The weighted-average grant date fair value per option for options granted during the three and nine months ended September 30, 2006 was $1.69 and $1.72, respectively. The weighted-average grant date fair value per option for options granted during the three and nine months ended September 30, 2005 was $2.36 and $2.79, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was $7,100 and $7,300, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2005 was $0 and $2,000, respectively. Cash proceeds from the exercise of stock options were $58,000 and $58,700 for the three and nine months ended September 30, 2006, respectively. Cash proceeds from the exercise of stock options were $0 and $6,000 for the three and nine months ended September 30, 2005, respectively. No income tax benefit was realized from the stock option exercises during the three and nine months ended September 30, 2006 and 2005. Stock-based compensation expense related to stock options recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was $0.1 million and $0.5 million, respectively. At September 30, 2006, there was $0.9 million of unrecognized stock-based compensation expense, net of estimated forfeitures related to non-vested options, that is expected to be recognized over a weighted-average period of 1.93 years.

The fair value of option grants was estimated by using the Black-Scholes-Merton model with the following weighted-average assumptions for the three and nine months ended September 30, 2006 and 2005, respectively:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Expected volatility | 64% | 89% | 69% | 90% |
| Dividend yield | 0 | 0 | 0 | 0 |
| Risk-free interest rate | 4.62% | 4.10% | 4.85% | 3.85% |

| | | | | |
|---|---|---|---|---|
| Expected term (in years) | 3.92 | 4.00 | 3.92 | 4.00 |

*Expected Volatility*: The Company s computation of expected volatility for the three and nine months ended September 30, 2006 is based on the historical volatility of the Company s stock for a time period equivalent to the expected life. Prior to the three and nine months ended September 30, 2006, the Company had used its historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information.

*Dividend Yield*: The dividend yield assumption is based on the Company s history and expectation of dividend payouts.

*Risk-Free Interest Rate:* The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.

*Expected Term:* The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined for the three and nine month ended September 30, 2006 based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior.

***1997 Employee Stock Purchase Plan***

Under the Company s ESPP, up to 1,021,887 shares of the Company s common stock may be issued. The Company s ESPP permits eligible employees to purchase common stock through payroll deductions up to 10% of their base wages at a purchase price of 85% of the lower of fair market value of the common stock at the beginning or end of each offering period. The Company has a two year rolling plan with four purchases every six months within the offering period. If the fair market value per share is lower on the purchase date than the beginning of the offering period, the current offering period terminates and a new two year offering period will commence. The Company s ESPP restricts the maximum amount of shares purchased by an individual to $25,000 worth of common stock each year. As of September 30, 2006, 384,616 shares were available for future issuance under the Company s ESPP.

The fair value of issuances under the Company s ESPP is estimated on the issuance date by applying the principles of FASB Technical Bulletin 97-1 ( FTB 97-1 ), *Accounting under Statement 123 for Certain Employee Stock Purchase Plan with a Look Back Option*, and using the Black-Scholes-Merton options pricing model. Stock-based compensation expense related to the Company s ESPP recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was $26,000 and $101,000, respectively. At September 30, 2006, there was $53,000 of unrecognized stock-based compensation expense related to outstanding ESPP shares that is expected to be recognized over a nineteen month period.

**3. Discontinued Operations**

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its DTV solutions business to Kudelski for total expected consideration of $11 million in cash, of which $9 million has been paid. Based on recent actions by Kudelski and the terms of the purchase agreement, the Company has made demand for payment of the remaining $2 million. The obligation to make the additional $2 million payment is disputed by Kudelski. Accordingly, the Company has not recorded the $2 million as receivable. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and nine months ended September 30, 2006 and 2005, the DTV solutions business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

Based on the carrying value of the assets and the liabilities attributed to the DTV solutions business on May 22, 2006, and the estimated costs and expenses incurred in connection with the sale, the Company recorded a net pretax gain of approximately $5.5 million, excluding the $2 million noted above.

The operating results for the discontinued operations of the DTV solutions business for the three and nine months ended September 30, 2006 and for the same period of 2005 are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Net revenue | $1,877 | $5,261 | $12,288 | $13,802 |
| Operating gain (loss) | $ (115) | $ 107 | $ (1,276) | $ (2,452) |
| Net income (loss) before income taxes | $ (141) | $ 162 | $ 2,919 | $ (2,337) |
| Income tax benefit (provision) | $ (8) | $ (3) | $ 75 | $ 167 |
| Income (loss) from discontinued operations | $ (149) | $ 158 | $ 2,994 | $ (2,171) |

During 2003, the Company completed two transactions to sell its retail Digital Media and Video business. On July 25, 2003, the Company completed the sale of its digital video business to Pinnacle Systems and on August 1, 2003, the Company completed the sale of its retail digital media reader business to Zio Corporation. As a result of these sales, the Company has accounted for the retail Digital Media and Video business as discontinued operations.

The operating results for the discontinued operations of the retail Digital Media and Video business for the three and nine months ended September 30, 2006 and for the same period of 2005 are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenue | $ | $ | $ | $ |
| Operating loss | $(75) | $ (59) | $(201) | $(244) |
| Net loss before income taxes | $(51) | $ (96) | $(134) | $(365) |
| Income tax provision | $(13) | $ (70) | $ (67) | $ (70) |
| Loss from discontinued operations | $(64) | $(166) | $(201) | $(435) |

**4. Short-Term Investments**

At September 30, 2006, approximately 50% of the short-term investment portfolio matures in 2006 and the remaining 50% in 2007. The fair value of short-term investments at September 30, 2006 and December 31, 2005 was as follows (in thousands):

| | September 30, 2006 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gain on Investments | Unrealized Loss on Investments | Estimated Fair Value |
| Corporate notes | $ 1,783 | $ 0 | $ (2) | $ 1,781 |
| U.S. government agencies | 5,550 | | (15) | 5,535 |
| Total | $ 7,333 | $ 0 | $ (17) | $ 7,316 |

| | December 31, 2005 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gain on Investments | Unrealized Loss on Investments | Estimated Fair Value |
| Corporate notes | $ 9,369 | $ 6 | $ (34) | $ 9,341 |
| U.S. government agencies | 9,490 | | (51) | 9,439 |
| Total | $ 18,859 | $ 6 | $ (85) | $ 18,780 |

***Cumulative Adjustment to Interest Income and Other Cumulative Comprehensive Gain***

In July 2005, during a review of the Company s investment holdings and the calculation of interest income and unrealized gains and losses on investments, the Company discovered an error in the recording of the amortization of investment premiums and discounts and the related interest income and unrealized gain (loss) on investments. As a result, interest income and unrealized loss on investments and the balance of unrealized loss included in other cumulative comprehensive gain for the years ended December 31, 2004 and 2003 have been overstated. The cumulative overstatement of interest income and unrealized loss on investments for periods prior to the three months ended June 30, 2005 was approximately $0.3 million. The effect of the error was not material to any relevant prior

period and had the amounts been recorded correctly in the prior periods, there would have been no effect on reported comprehensive loss or total stockholder s equity. To correct this error, the Company recorded the cumulative $0.3 million as a reduction in interest income and a decrease in unrealized loss on investments during the three-month period ended June 2005.

During each quarter, SCM evaluates investments for possible asset impairment by examining a number of factors, including the current economic conditions and markets for each investment, as well as its cash position and anticipated cash needs for the short and long term. In addition, the Company evaluates severity and duration in each reporting period. At September 30, 2006,

approximately $6.5 million of the short-term investment portfolio has an unrealized loss and approximately $4.5 million of those investments have been in an unrealized loss position for more than one year. Of the $17,000 unrealized loss at September 30, 2006, approximately $14,000 relates to investments that have been in an unrealized loss position for more than one year. The Company believes these fair value declines are the result of rising short-term interest rates. For the three and nine months ended September 30, 2006 and 2005, no impairment of the investments was identified based on the evaluations performed.

**5. Inventories**

Inventories consist of (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Raw materials | $ 1,405 | $ 2,430 |
| Work-in-process | | 2,435 |
| Finished goods | 821 | 1,140 |
| Total | $ 2,226 | $ 6,005 |

The reduction in inventories and in particular work-in-progress is primarily the result of the outsourcing of the Company s manufacturing operations from its Singapore facility to contract manufacturers.

**6. Property and Equipment**

Property and equipment consists of (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Land | $ 122 | $ 260 |
| Building and leasehold improvements | 1,827 | 3,187 |
| Furniture, fixtures and office equipment | 3,115 | 5,333 |
| Automobiles | 1 | 58 |
| Purchased software | 3,138 | 4,018 |
| Total | 8,203 | 12,856 |
| Accumulated depreciation | (6,737) | (9,806) |
| Property and equipment, net | $ 1,466 | $ 3,050 |

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**7. Intangible Assets**

Intangible assets are primarily associated with the Company s European operations and consist of the following (in thousands):

| | | September 30, 2006 | | | December 31, 2005 | | |
|---|---|---|---|---|---|---|---|
| | Amortization Period | Gross Carrying Value | Accumulated Amortization | Net | Gross Carrying Value | Accumulated Amortization | Net |
| Customer relations | 60 months | $ 1,582 | $ (1,387) | $ 195 | $ 1,476 | $ (1,071) | $ 405 |
| Core technology | 60 months | 1,793 | (1,556) | 237 | 1,673 | (1,199) | 474 |
| Total intangible assets | | $ 3,375 | $ (2,943) | $ 432 | $ 3,149 | $ (2,270) | $ 879 |

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, only SCM s intangible assets relating to core technology and customer relations are subject to amortization.

Amortization expense related to intangible assets for continuing operations was $0.2 million and $0.5 million for the three and nine months ended September 30, 2006, respectively, and $0.2 million and $0.5 million for the three and nine months ended September 30, 2005.

Estimated future amortization of intangible assets is as follows (in thousands):

| Fiscal Year | Amount |
|---|---|
| 2006 (remaining 3 months) | $ 170 |
| 2007 | 262 |
| Total | $ 432 |

**8. Restructuring and Other Charges**

*Continuing Operations*

During the three and nine months ended September 30, 2006, SCM incurred net restructuring and other charges related to continuing operations of approximately $0.4 million and $1.3 million, respectively. During the three and nine months ended September 30, 2005, SCM incurred net restructuring and other charges related to continuing operations of approximately $0.2 million and $0.4 million, respectively.

Accrued liabilities related to restructuring actions and other activities during the nine months ended September 30, 2006 and during the year ended December 31, 2005 consist of the following (in thousands):

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| | Lease/Contract Commitments | Severance | Other Costs | Total |
|---|---|---|---|---|
| Balances as of January 1, 2005 | $ 52 | $ 431 | $ 5,132 | $ 5,615 |
| Provision for 2005 | | 699 | 25 | 724 |
| Changes in estimates | 7 | (12) | 127 | 122 |
| | 7 | 687 | 152 | 846 |
| Payments and other changes in 2005 | (27) | (966) | (4,994) | (5,987) |
| Balances as of December 31, 2005 | 32 | 152 | 290 | 474 |
| Provision for Q1 2006 | | 519 | | 519 |
| Changes in estimates | (2) | | | (2) |
| | (2) | 519 | | 517 |
| Payments and other changes in Q1 2006 | (4) | (52) | 7 | (49) |
| Balances as of March 31, 2006 | $ 26 | $ 619 | $ 297 | $ 942 |
| Provision for Q2 2006 | | 342 | | 342 |
| Changes in estimates | | | | |
| | | 342 | | 342 |
| Payments and other changes in Q2 2006 | (3) | (248) | 10 | (241) |
| Balances as of June 30, 2006 | $ 23 | $ 713 | $ 307 | $ 1,043 |
| Provision for Q3 2006 | 33 | 394 | | 427 |
| Changes in estimates | | | | |
| | 33 | 394 | | 427 |
| Payments and other changes in Q3 2006 | (38) | (806) | 4 | (840) |
| Balances as of September 30, 2006 | $ 18 | $ 301 | $ 311 | $ 630 |

For the three and nine months ended September 30, 2006, restructuring and other charges primarily related to severance costs in connection with a reduction in force resulting from the Company s decision to transfer all manufacturing operations from its Singapore facility to contract manufacturers as well as the decision to transfer the corporate headquarter functions from California to Germany. Approximately $0.2 million of the restructuring amount relates to severance for manufacturing personnel for the nine month period and is therefore recorded in cost of revenue. The remaining $1.1 million in the nine month period is recorded in operating expenses and is primarily made up of severance for non-manufacturing personnel. The Company believes the restructuring activity is substantially completed and that any future costs incurred will be insignificant.

As shown in the table above in Payments or write offs in 2005 Other Costs, in April 2005, SCM made a payment to the French government of approximately $4.7 million as then calculated, related to Value Added Tax ( VAT ) in respect of sales transactions with a former customer. In connection with this payment, SCM entered into an agreement

with the customer whereby the customer agreed to seek a refund from the French government for the VAT paid with respect to the products it purchased from the Company, and then remit the refunded amount to SCM. On June 9, 2006, the customer remitted to the Company the full amount including currency gains totaling $5.0 million, of which $4.2 million was recognized as other income from discontinued operations. See Note 12 for further discussion.

*Discontinued Operations*

During the three and nine months ended September 30, 2006, SCM incurred restructuring and other credits of approximately $25,000 and restructuring and other charges of approximately $31,000, respectively, related to discontinued operations. During the three and nine months ended September 30, 2005, SCM incurred restructuring and other charges related to discontinued operations of approximately $0.1 million and $0.1 million, respectively.

Accrued liabilities related to the Digital Media and Video restructuring actions and other activities during the nine months ended September 30, 2006 and during the year ended December 31, 2005 consist of the following (in thousands):

| | Legal Settlements | Lease/Contract Commitments | Other Costs | Total |
|---|---|---|---|---|
| Balances as of January 1, 2005 | $ | $ 3,960 | $ 304 | $ 4,264 |
| Provision for 2005 | 1,700 | | 648 | 2,348 |
| Changes in estimates | | (111) | | (111) |
| | 1,700 | (111) | 648 | 2,237 |
| Payments and other changes | (1,700) | (651) | (727) | (3,078) |
| Balances as of December 31, 2005 | | 3,198 | 225 | 3,423 |
| Provision for Q1 2006 | | | 5 | 5 |
| Changes in estimates | | (24) | | (24) |
| | | (24) | 5 | (19) |
| Payments and other changes in Q1 2006 | | (124) | (190) | (314) |
| Balances as of March 31, 2006 | $ | $ 3,050 | $ 40 | $ 3,090 |
| Provision for Q2 2006 | | | | |
| Changes in estimates | | 75 | | 75 |
| | | 75 | | 75 |
| Payments and other changes in Q2 2006 | | (107) | | (107) |
| Balances as of June 30, 2006 | $ | $ 3,018 | $ 40 | $ 3,058 |
| Provision for Q3 2006 | | | | |
| Changes in estimates | | (25) | | (25) |
| | | (25) | | (25) |
| Payments and other changes in Q3 2006 | | (63) | | (63) |
| Balances as of June 30, 2006 | $ | $ 2,930 | $ 40 | $ 2,970 |

Discontinued operation costs for the three and nine months ended September 30, 2006 primarily related to changes in estimates for lease obligations.

**9. Segment Reporting, Geographic Information and Major Customers**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information,* establishes standards for the reporting by public business enterprises of information about operating segments, products and services, geographic areas, and major customers. The method for determining what information to report is based on the way that management organizes the operating segments within the Company for making operating decisions and assessing financial performance. The Company s chief operating decision maker is considered to be its executive staff, consisting of the Chief Executive Officer, Chief Financial Officer and Vice President Marketing.

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its DTV solutions business to Kudelski. In accordance with SFAS No. 144, *Accounting for the*

*Impairment or Disposal of Long Lived Assets*, for the three and nine months ended September 30, 2006 and 2005, this business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

The Company s continuing operations provide secure digital access solutions to OEM customers in two markets segments: PC Security and Flash Media Interface. The executive staff reviews financial information and business performance along these two business segments. The Company evaluates the performance of its segments at the revenue and gross margin level. The Company s reporting systems do not track or allocate operating expenses or assets by segment. The Company does not include intercompany transfers between segments for management purposes.

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Summary information by segment for the three and nine months ended September 30, 2006 and for the same periods of 2005 is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| PC Security: | | | | |
| Net revenue | $5,096 | $3,898 | $16,438 | $12,566 |
| Gross profit | 1,621 | 1,414 | 6,480 | 4,147 |
| Gross profit % | 32% | 36% | 39% | 33% |
| Flash Media Interface: | | | | |
| Net revenue | $2,300 | $4,153 | $ 7,747 | $ 7,968 |
| Gross profit | 504 | 1,689 | 1,454 | 3,886 |
| Gross profit % | 22% | 41% | 19% | 49% |
| Total: | | | | |
| Net revenue | $7,396 | $8,051 | $24,185 | $20,534 |
| Gross profit | 2,125 | 3,103 | 7,934 | 8,033 |
| Gross profit % | 29% | 39% | 33% | 39% |

Geographic net revenue is based on selling location. Information regarding net revenue by geographic region is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenue | | | | |
| United States | $ 3,242 | $ 3,807 | $ 10,407 | $ 8,825 |
| Europe | 3,045 | 3,094 | 10,212 | 6,996 |
| Asia-Pacific | 1,109 | 1,150 | 3,566 | 4,713 |
| Total | $ 7,396 | $ 8,051 | $ 24,185 | $ 20,534 |
| % of net revenue | | | | |
| United States | 44% | 48% | 43% | 43% |
| Europe | 41% | 38% | 42% | 34% |
| Asia-Pacific | 15% | 14% | 15% | 23% |

Customers comprising 10% or greater of the Company s net revenue are summarized as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Customer A based in the USA | 14% | * | 12% | * |
| Customer B based in the USA | * | 27% | * | 20% |
| Customer C based in Asia | * | * | * | 10% |
| Customer D based in Europe | 13% | 17% | * | * |

| Total | 27% | 44% | 12% | 30% |
|---|---|---|---|---|

* Net revenue derived from customer represented less than 10% for the period.

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Customers representing 10% or greater of the Company s accounts receivable are summarized as follows:

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Customer A based in Asia | * | 18% |
| Customer B based in the USA | 16% | 17% |
| Total | 16% | 35% |

* Customer s accounts receivable represented less than 10% for the periods presented.

Long-lived assets by geographic location as of September 30, 2006 and December 31, 2005, are as follows (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Property and equipment, net: | | |
| Asia-Pacific | $ 1,264 | $ 1,644 |
| Europe | 171 | 1,369 |
| United States | 31 | 37 |
| Total | $ 1,466 | $ 3,050 |

**10. Commitments**

The Company leases its facilities, certain equipment, and automobiles under noncancelable operating lease agreements. These lease agreements expire at various dates during the next ten years.

As of September 30, 2006, the Company had a $2 million time deposit with a financial institution, which was restricted as to use and represented compensating balances for a bank guarantee for the benefit of inventory purchases by a contract manufacturing supplier. This balance is included in restricted short-term investment on the balance sheet.

Purchases for inventories are highly dependent upon forecasts of the customers demand. Due to the uncertainty in demand from its customers, the Company may have to change, reschedule, or cancel purchases or purchase orders from its suppliers. These changes may lead to vendor cancellation charges on these purchases or contractual commitments. As of September 30, 2006, purchase and contractual commitments were approximately $6.0 million, of which approximately $1.7 million relate to the sold DTV solutions business.

The Company provides warranties on certain product sales, which range from twelve to twenty-four months, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. The Company currently establishes warranty reserves based on historical warranty costs for each product line combined with liability estimates based on the prior twelve months sales activities. If actual return rates

and/or repair and replacement costs differ significantly from the Company s estimates, adjustments to recognize additional cost of sales may be required in future periods.



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Components of the reserve for warranty costs for the nine months ended September 30, 2006 and 2005 were as follows (in thousands):

| | 2006 | 2005 |
|---|---|---|
| Balances at January 1 | $ 153 | $ 244 |
| Additions related to sales during the period | 210 | 288 |
| Warranty costs incurred during the period | (62) | (95) |
| Adjustments to accruals related to prior period sales | (90) | (266) |
| Adjustments to accruals related to sale of the DTV Solutions business | (28) | |
| Balances at September 30 | $ 183 | $ 171 |

**11. Net Income (Loss) per Common Share**

The following table sets forth the computation of basic and diluted net income (loss) per common share (in thousands, except per share amounts):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net loss from continuing operations | $ (3,680) | $ (1,950) | $ (8,372) | $ (5,940) |
| Income (loss) from discontinued operations | (189) | (97) | 8,080 | (2,678) |
| Net income (loss) | $ (3,869) | $ (2,047) | $ (292) | $ (8,618) |
| Shares used in income (loss) per common share basic | 15,648 | 15,542 | 15,623 | 15,517 |
| Effect of dilutive securities: | | | | |
| Employee and director stock options | | | 23 | |
| Shares used in income (loss) per common share diluted | 15,648 | 15,542 | 15,646 | 15,517 |
| Net income (loss) per common share basic and diluted | | | | |
| Continuing operations | $ (0.24) | $ (0.12) | $ (0.54) | $ (0.39) |
| Discontinued operations | $ (0.01) | $ (0.01) | $ 0.52 | $ (0.17) |
| Net income (loss) per common share basic and diluted | $ (0.25) | $ (0.13) | $ (0.02) | $ (0.56) |

The computation of diluted net loss per common share from continuing operations for the three and nine months ended September 30, 2006, excludes the effect of the potential exercise of options to purchase approximately 16,000 and 23,000 shares, respectively, because the effect would be anti-dilutive in periods when there is a net loss. The computation of diluted net loss per common share for the three and nine months ended September 30, 2006, also excludes the effect of the potential exercise of options to purchase approximately 2.3 million and 2.5 million shares, respectively, because the option exercise price was greater than the average market price of the common shares and the effect would have been anti-dilutive.

The computation of diluted net loss per common share for the three and nine months ended September 30, 2005, excludes the effect of the potential exercise of options to purchase approximately 14,000 and 59,000 shares, respectively because the effect would be anti-dilutive in periods when there is a net loss. The computation of diluted net loss per common share for the three and nine months ended September 30, 2005, also excludes the effect of the potential exercise of options to purchase approximately 2.6 million and 2.5 million shares, respectively because the option exercise price was greater that the average market price of the common shares and the effect would have been anti-dilutive.



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**12. Legal Proceedings**

In December 2005, a complaint was filed in France against SCM Microsystems GmbH, one of the Company s wholly-owned subsidiaries, by Aston France S.A., a current competitor of the Company s DTV solutions business in the conditional access modules market, alleging participation by SCM Microsystems GmbH in the counterfeiting of Aston s conditional access modules. Aston was one of the Company s digital television customers until November 2002, when the Company entered into a settlement agreement (the 2002 Settlement ) with Aston that included the Company s agreement to cancel binding orders made by Aston and the return by Aston of unsold inventory to the Company. In April 2005, the Company entered into an agreement with Aston whereby Aston agreed to (i) seek a refund from the French government for approximately $4.7 million in value added taxes that the Company paid to the French government with respect to products that Aston purchased from the Company prior to November 2002 and (ii) remit the refunded amount to the Company. On October 13, 2005 the French government refunded approximately $4.7 million (the VAT Refund ) to Aston, but Aston did not remit such amount to the Company. Shortly thereafter, Aston filed the action described above.

In its complaint filed in France, Aston claims damages in the amount of approximately $69 million. The Company believes, however, that the allegations made by Aston in their complaint are in contradiction to the statements made by Aston as part of the 2002 Settlement. On February 2, 2006, the Company filed a counterclaim against Aston in Germany alleging damages in the amount of approximately $14 million resulting from Aston s fraudulent misrepresentation and breach of contract in connection with the 2002 Settlement. Aston filed its response to the Company s counterclaim on July 28, 2006. The Company replied on September 18, 2006 and expects a first court hearing to be scheduled soon.

In November 2005, Aston obtained a preliminary injunction in France to stay the Company s claim for recovery of the VAT Refund and on February 21, 2006, the court that issued the injunction revised its order such that only approximately $1.2 million of VAT Refund amount was still covered by the injunction. Both Aston and the Company appealed against this order. On June 1, 2006, a French appeals court released the injunction with respect to the entire amount of the VAT Refund and this decision has become final. Thereafter, the Company was able to enforce its claim for the VAT Refund and obtain a seizure of considerable amounts of Aston s assets. Subsequently, on June 9, 2006, Aston paid to the Company the full VAT Refund, including currency gains, in an amount of approximately $5.0 million. The Company is currently attempting to enforce a contractual penalty payment under the April 2005 agreement relating to the VAT Refund and to obtain interest on the amount of the VAT Refund for late payment.

The Company believes that the claims made by Aston in its complaint are without merit and were for the sole purpose of preventing or delaying the Company s recovery of the VAT Refund. The Company intends to vigorously defend itself against the claims made by Aston and prosecute its counterclaims against Aston. Such efforts, however, may result in the incurrence of significant expense and cost and demand significant use of management s limited time and resources. There is no assurance that the Company will be successful in defending itself against Aston s claims or in prosecuting its counterclaim against Aston, in each case, in a timely manner, in full or at all. If these claims are decided against the Company, the result may have a material and adverse effect on the Company.

From time to time, the Company could be subject to other claims arising in the ordinary course of business or could be a defendant in other lawsuits. While the outcome of such claims or other proceedings can not be predicted with certainty, SCM s management currently expects that any such liabilities, to the extent not provided for by insurance or otherwise, will not have a material adverse effect on the Company s financial condition, results of operations or cash flows.

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## Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

*This Quarterly Report on Form 10-Q contains forward-looking statements for purposes of the safe harbor provisions under the Private Securities Litigation Reform Act of 1995. For example, statements, other than statements of historical facts regarding our strategy, future operations, financial position, projected results, estimated revenues or losses, projected costs, prospects, plans, market trends, competition and objectives of management constitute forward-looking statements. In some cases, you can identify forward-looking statements by terms such as will, believe, could, should, would, may, anticipate, intend, plan, estimate, expect, project or the negative of these terms or other similar expressions. Although we believe that our expectations reflected in or suggested by the forward-looking statements that we make in this Quarterly Report on Form 10-Q are reasonable, we cannot guarantee future results, performance or achievements. You should not place undue reliance on these forward-looking statements. All forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our expectations change, whether as a result of new information, future events or otherwise. We also caution you that such forward-looking statements are subject to risks, uncertainties and other factors, not all of which are known to us or within our control, and that actual events or results may differ materially from those indicated by these forward-looking statements. We disclose some of the important factors that could cause our actual results to differ materially from our expectations under Part II Item 1A, Risk Factors and elsewhere in this Quarterly Report on Form 10-Q. These cautionary statements qualify all of the forward-looking statements included in this Quarterly Report on Form 10-Q that are attributable to us or persons acting on our behalf.*

*The following information should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto set forth in Part I, Item 1 of this Quarterly Report on Form 10-Q. We also urge readers to review and consider our disclosures describing various factors that could affect our business, including the disclosures under the headings Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors and the audited financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission on March 17, 2006, as amended by Form 10-K/A filed on April 28, 2006.*

**Overview**

SCM Microsystems, Inc. was incorporated in 1996 under the laws of the state of Delaware. We design, develop and sell hardware, software and silicon solutions that enable people to conveniently and securely access digital content and services. We sell our secure digital access products into two market segments: PC Security and Flash Media Interface.

For the PC Security market, we offer smart card reader technology that enables authentication of individuals for applications such as electronic passports, electronic healthcare cards, secure logical access to PCs and networks, and physical access to facilities.

For the Flash Media Interface market, we offer digital media readers that are used to transfer digital content to and from various flash media. These readers are primarily used in digital photo kiosks.

We sell our products primarily to original equipment manufacturers, or OEMs, who typically either bundle our products with their own solutions, or repackage our products for resale to their customers. Our OEM customers include: government contractors, systems integrators, large enterprises and computer manufacturers, as well as banks and other financial institutions for our smart card readers; and computer electronics and photographic equipment manufacturers for our digital media readers. We sell and license our products through a direct sales and marketing organization, as well as through distributors, value added resellers and systems integrators worldwide.

On May 22, 2006 we completed the sale of our Digital Television solutions ( DTV solution ) business to Kudelski S.A. As a result, we have accounted for the DTV solutions business as discontinued operations, and the statements of operations and cashflows for all periods presented reflect the discontinuance of this business. (See Note 3 to the Condensed Consolidated Financial Statements.)

In our continuing operations, revenues have grown over the past few quarters, but the rate and sustainability of this progress is unpredictable due to significant variations in demand for our products quarter to quarter. This is

particularly true for our PC Security products, many of which are targeted at new smart card-based ID programs run by various U.S., European and Asian governments. Sales of our smart card readers and chips for government programs are impacted by the immature nature of the applications being addressed, testing and compliance schedules of government bodies and roll-out schedules for application deployments, all of which contribute to variability in demand from quarter to quarter. Sales of our Flash Media Interface products

are less subject to this variability; however, we are dependent on a small number of customers in both of our primary product segments, which can result in significant fluctuations in sales levels from one period to another.

We have adopted a strategy to grow revenue that is based on introducing new PC Security and Flash Media Interface products to address new market opportunities. To date, this strategy has been only partially successful. Our target markets have not grown or developed as quickly as we had expected and we have experienced delays in the development and shipment of new products designed to take advantage of new market opportunities.

In both our PC Security and Flash Media Interface businesses, pricing pressure has increased over the last few months, resulting in lower gross profits. To address an increasingly competitive environment, we have put in place cost reduction programs that we believe will result in margin improvements going forward.

We have taken measures to reduce operating expenses over the last several quarters, including reducing headcount, reducing the use of outside contract personnel and limiting certain expenses such as tradeshow participation. Through September 2005, we manufactured our products primarily using internal resources in Singapore, supplemented by contract manufacturers in Asia. Since October 2005, we have ceased to manufacture any of our own components or products internally and have shifted these activities to external contract manufacturers, which we believe will yield further savings and efficiencies. In addition, during fiscal 2006 we consolidated our global business operations into fewer locations, which included the closure of some facilities and the transition of certain corporate functions from California to Germany. As this consolidation of our global business operations is now substantially complete, we expect that our general and administrative expenses will decrease in the fourth quarter of 2006.

**Critical Accounting Policies and Estimates**

Management s Discussion and Analysis of Financial Condition and Results of Operations discusses our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, including those related to product returns, customer incentives, bad debts, inventories, asset impairment, deferred tax assets, accrued warranty reserves, restructuring costs, contingencies and litigation. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following critical accounting policies, among others, affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

- We recognize product revenue upon shipment provided that risk and title have transferred, a purchase order has been received, collection is determined to be reasonably assured and no significant obligations remain. Maintenance revenue is deferred and amortized over the period of the maintenance contract. Provisions for estimated warranty repairs and returns and allowances are provided for at the time products are shipped. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

- We write down inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual demand or market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

- The carrying value of our net deferred tax assets reflects that we have been unable to generate sufficient taxable income in certain tax jurisdictions. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before we are able to realize their benefit, or that future deductibility is uncertain. Management evaluates the realizability of the deferred tax assets quarterly. At September 30, 2006 we

have recorded valuation allowances against substantially all of our deferred tax assets. The deferred tax assets are still available for us to use in the future to offset taxable income, which would result in the recognition of a tax benefit and a reduction in our effective tax rate. The divestiture of our retail Digital Media and Video business and the sale of our DTV solutions business, as well as future changes to the operating structure of our strategic focus on our continuing operations, may limit our ability to utilize our deferred tax assets.

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We accrue the estimated cost of product warranties during the period of sale. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers, our warranty obligation is affected by actual warranty costs, including material usage or service delivery costs incurred in correcting a product failure. If actual material usage or service delivery costs differ from our estimates, revisions to our estimated warranty liability would be required.

Statement of Financial Accounting Standard No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* requires that a liability for a cost associated with an exit or disposal activity initiated after December 31, 2002 be recognized when the liability is incurred and that the liability be measured at fair value. In connection with plans we have adopted, we recorded estimated expenses for severance and outplacement costs, lease cancellations, asset write-offs and other restructuring costs. We continually evaluate the adequacy of the remaining liabilities under our restructuring initiatives. Although we believe that these estimates accurately reflect the costs of our restructuring plans, actual results may differ, thereby requiring us to record additional provisions or reverse a portion of such provisions.

**Recent Accounting Pronouncements**

During the first quarter of fiscal 2006, we adopted the provisions of, and accounted for stock-based compensation in accordance with, the Financial Accounting Standards Board s ( FASB ) SFAS No. 123 revised 2004 ( SFAS 123(R) ), *Share-Based Payment,* which replaced SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 ( APB 25 ), *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. We elected to use the modified-prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123(R) apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The adoption of SFAS 123(R) did not have a material impact on our consolidated financial position, results of operations and cash flows. See Note 2 to Consolidated Financial Statements for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if we had recorded stock-based compensation expense.

In April 2006, the FASB issued FASB Staff Position No. FIN 46(R)-6 ( FSP FIN 46(R)-6 ), which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, as amended ( FIN 46(R) ). The variability that is considered in applying FIN 46(R) affects the determination of (a) whether the entity is a variable interest entity, (b) which interests are variable interests in the entity and (c) which party, if any, is the primary beneficiary of the variable interest entity. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary. FSP FIN 46(R)-6 provides additional guidance to consider for determining variability. FSP FIN 46(R)-6 is effective beginning the first day of the first reporting period beginning after June 15, 2006. After evaluating FSP FIN 46(R)-6, we determined that there is no impact to our consolidated financial position, results of operations or cash flows from its adoption.

In July 2006, the FASB issued FASB Interpretation No. 48 *Accounting For Uncertain Tax Positions* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109 *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of FIN 48 to our financial position and results of operations.

In June 2006, the Financial Accounting Standards Board, or FASB, ratified Emerging Issues Task Force, or EITF, Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* ( Issue No. 06-03 ). Under Issue No. 06-03, a company must disclose its accounting policy regarding the gross or net presentation of certain taxes. If taxes included in gross revenues are significant, a company must disclose the amount of such taxes for each period for which an income statement is presented (i.e., both interim and annual periods). Taxes within the scope of this Issue are those that are imposed on and concurrent with a specific revenue-producing transaction. Taxes assessed on an entity s activities over a period of time, such as gross receipts taxes, are not within

the scope of the issue. Issue No. 06-03 is effective for the first annual or interim reporting period beginning after December 15, 2006. We are currently evaluating the impact of EITF, Issue No. 06-03 to our financial position and results of operations.

In September 2006, the Securities and Exchange Commission ( SEC ) published Staff Accounting Bulletin (SAB) No 108. SAB 108 expresses the staff views regarding the process of quantifying financial statement misstatements. The bulletin prescribes the use of rollover and iron curtain approaches in quantifying misstatements. Rollover approach quantifies a misstatement based on the amount of the error originating in the current year income statement. Iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the year, irrespective of the misstatement s year(s) of origination. The statement is effective immediately. We did not have any misstatements that were determined to be material on the basis of either of the approaches mentioned above.

**Results of Operations**

*Net Revenue.* Summary information by product segment for the three and nine months ended September 30, 2006 and 2005 is as follows (in thousands):

| | Three months ended September 30, | | % change period to period | Nine months ended September 30, | | % change period to period |
|---|---|---|---|---|---|---|
| | **2006** | **2005** | | **2006** | **2005** | |
| PC Security | | | | | | |
| Revenue | $5,096 | $3,898 | 31% | $16,438 | $12,566 | 31% |
| Gross profit | 1,621 | 1,414 | | 6,480 | 4,147 | |
| Gross profit % | 32% | 36% | | 39% | 33% | |
| Flash Media Interface | | | | | | |
| Revenue | $2,300 | $4,153 | (45)% | $ 7,747 | $ 7,968 | (3)% |
| Gross profit | 504 | 1,689 | | 1,454 | 3,886 | |
| Gross profit % | 22% | 41% | | 19% | 49% | |
| Total: | | | | | | |
| Revenue | $7,396 | $8,051 | (8)% | $24,185 | $20,534 | 18% |
| Gross profit | 2,125 | 3,103 | | 7,934 | 8,033 | |
| Gross profit % | 29% | 39% | | 33% | 39% | |

Net revenue for the three months ended September 30, 2006 was $7.4 million, down 8% compared to $8.1 million for the same period of 2005. This decrease in revenue resulted from a decrease in sales of our Flash Media Interface products, offset by a proportionally smaller increase in sales of our PC Security products. For the nine months ended September 30, 2006, net revenue was $24.2 million, up 18% from revenue of $20.5 million in the first nine months of 2005. The increase in revenue in the nine-month period resulted from higher sales of our PC Security products, offset by a slight decrease in sales of our Flash Media Interface products.

In our PC Security product line, sales were $5.1 million in the third quarter of 2006, an increase of 31% from sales of $3.9 million in the third quarter of 2005. For the first nine months of 2006, sales were $16.4 million, up 31% from sales of $12.6 million for the first nine months of 2005. Higher sales in both the third quarter and the first nine months of 2006 compared with the same periods of the previous year primarily resulted primarily from an increase in sales of our Class I, or basic smart card readers. These readers are used primarily for personal identification and PC/network access security programs by the U.S. government and corporate enterprises worldwide. Our PC Security product line consists of smart card readers and related chip technology that are utilized principally in security programs where smart cards are used to authenticate the identity of people in order to control access to computers, computer networks,

borders, buildings and other facilities. Revenue in this product line is typically tied to large security projects of governments, financial institutions or enterprises and is subject to significant variability based on the size and timing of customer orders. The timing of any new projects that may create or increase demand for smart card readers is unpredictable.

Revenue from our Flash Media Interface product line was $2.3 million in the third quarter of 2006, down 45% from revenue of $4.2 million in the third quarter of 2005. This decrease reflects both the unfavorable comparison with the third quarter of 2005, when we experienced unusually strong sales of a new digital media reader designed to be incorporated in consumer electronics products, as well as from a reduction in orders from a significant customer in fiscal 2006 including the third quarter. For the first

nine months of 2006, sales were $7.8 million, a decrease of 3% compared with sales of $8.0 million in the first nine months of 2005. The decrease in the nine-month period reflects the unfavorable comparison and the reduction of orders from a significant customer in the third quarter of 2006 compared with the same quarter of the prior year as discussed above. Flash Media Interface revenues consist of sales of digital media readers to provide an interface for flash memory cards in digital photography kiosks and in digital television sets, which are used to download and print digital photos. Revenue in this product line can vary significantly quarter to quarter due to variability in the size and timing of customer orders.

*Gross Profit.* Gross profit for the third quarter of 2006 was $2.1 million, or 29% of revenue, compared to $3.1 million, or 39% of revenue in the same period of 2005.

Gross profit for our PC Security products was 32% for the third quarter of 2006 compared with 36% for the third quarter of 2005. The decrease in gross profit in the third quarter of 2006 compared with the same period of 2005 reflects the impact of increased pricing pressure on products sold during the 2006 period. Gross profit for our Flash Media Interface products was 22% for the third quarter of 2006, compared with 41% for the third quarter of 2005. This decrease reflects increased pricing pressure, as well as a less favorable mix of products sold during the 2006 period.

For the first nine months of 2006, gross profit was $7.9 million, or 33% of revenue, compared with $8.0 million, or 39% of revenue for the first nine months of 2005.

Our gross profit has been and will continue to be affected by a variety of factors, including, without limitation, competition, the volume of sales in any given quarter, product configuration and mix, the availability of new products, product enhancements, software and services, and the cost and availability of components. Accordingly, gross profit percentages are expected to continue to fluctuate from period to period.

*Research and Development.*

| | Three months ended September 30 | | % change period to period | Nine months ended September 30 | | % change period to period |
|---|---|---|---|---|---|---|
| *(in thousands)* | **2006** | **2005** | | **2006** | **2005** | |
| Expenses | $1,085 | $1,048 | 4% | $3,115 | $2,947 | 6% |
| Percentage of total revenues | 15% | 13% | | 13% | 14% | |

Research and development expenses consist primarily of employee compensation and fees for the development of prototype products. Research and development costs are primarily related to hardware and chip development. For the third quarter of 2006, research and development expenses were $1.1 million, or 15% of revenue, compared with $1.0 million, or 13% of revenue in the third quarter of 2005. For the first nine months of 2006, research and development expenses were $3.1 million, or 13% of revenue, compared with $2.9 million, or 14% of revenue for the first nine months of 2005. We expect our research and development expenses to vary based on future project demands.

*Selling and Marketing.*

| | Three months ended September 30 | | % change period to period | Nine months ended September 30 | | % change period to period |
|---|---|---|---|---|---|---|
| *(in thousands)* | **2006** | **2005** | | **2006** | **2005** | |
| Expenses | $2,292 | $1,609 | 42% | $6,053 | $5,282 | 15% |
| Percentage of total revenues | 31% | 20% | | 25% | 26% | |

Selling and marketing expenses consist primarily of employee compensation as well as tradeshow participation and other marketing costs. Selling and marketing expenses in the third quarter of 2006 were $2.3 million, or 31% of revenue, compared with $1.6 million, or 20% of revenue in the third quarter of 2005. For the first nine months of 2006, sales and marketing expenses were $6.1 million, or 25% of revenue, compared with $5.3 million, or 26% of revenue in the first nine months of 2005. Sales and marketing expenses in the three and nine months ended September 30, 2006 included $0.3 million in severance costs related to our office consolidation and closure activities in the third quarter of 2006. We expect our sales and marketing costs will vary as we continue to align our resources to address existing and new market opportunities.

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*General and Administrative.*

| (in thousands) | Three months ended September 30 2006 | 2005 | % change period to period | Nine months ended September 30 2006 | 2005 | % change period to period |
|---|---|---|---|---|---|---|
| Expenses | $2,208 | $2,492 | (11)% | $6,340 | $6,958 | (9)% |
| Percentage of total revenues | 30% | 31% | | 26% | 34% | |

General and administrative expenses consist primarily of compensation expenses for employees performing our administrative functions, professional fees arising from legal, auditing and other consulting services. In the third quarter of 2006, general and administrative expenses were $2.2 million, or 30% of revenue, compared with $2.5 million, or 31% of revenue in the third quarter of 2005. For the first nine months of 2006, general and administrative expenses were $6.3 million, or 26% of revenue, compared with $7.0 million, or 34% of revenue in the first nine months of 2005. General and administrative expense in the three and nine months ended September 30, 2006 included $0.1 million in charges for severance, contract termination and office consolidation related to our office consolidation and closure activities in the third quarter of 2006. We expect that our general and administrative costs will decrease further in the fourth quarter of 2006 as the consolidation of our global business operations has been substantially completed.

*Amortization of Goodwill and Intangibles.*

| (in thousands) | Three months ended September 30 2006 | 2005 | % change period to period | Nine months ended September 30 2006 | 2005 | % change period to period |
|---|---|---|---|---|---|---|
| Expenses | $170 | $163 | 4% | $495 | $513 | (4)% |
| Percentage of total revenues | 2% | 2% | | 2% | 2% | |

Amortization of intangible assets in the third quarter of 2006 was $0.2 million, compared with $0.2 million for the same period of 2005. For the first nine months of 2006, amortization of intangible assets was $0.5 million, compared with $0.5 million for the first nine months of 2005.

*Restructuring and Other Charges (Credits).* For the three and nine months ended September 30, 2006, we recorded restructuring and other charges of $0.4 million and $1.1 million, respectively, primarily related to severance costs for general and administrative personnel that are affected by our decision to relocate certain corporate headquarter functions in California to Germany as well as the outsourcing of our manufacturing operations from our Singapore facility to contract manufacturers. Severance costs for manufacturing personnel have been recorded in cost of revenue (See Note 8 to Condensed Consolidated Financial Statements).

For the third quarter of fiscal 2005 we recorded restructuring and other charges of $22,000 relating to severance costs for a reduction in force of non-manufacturing personnel resulting from our decision to outsource manufacturing operations in our Singapore facility to contract manufacturers. For the first nine months of 2005, we recorded restructuring and other charges of $0.2 million, primarily related to changes in estimates for European transactional tax related matters.

*Interest and Other Income:* Interest and other income, net consists of interest earned on invested cash, other income and expense and foreign currency gains or losses. In the third quarter of 2006 interest income resulting from invested cash balances was $0.4 million, compared with interest income of $0.3 million for the third quarter of 2005. In the first nine months of 2006, interest income was $0.9 million, compared with interest income of $0.5 million in

the first nine months of 2005, which included an adjustment to interest income taken in the second quarter of 2005 for the correction of an error in accounting for the amortization of premiums and discounts on investments. The cumulative correction of the error resulted in a reduction of interest income in the first nine months of 2005 of approximately $0.3 million. (See Note 4 to Condensed Consolidated Financial Statements for additional discussion of this adjustment).

Lower interest and other income figures in the first nine months of 2006 were primarily the result of less favorable foreign currency exchange rates compared with the prior year period.

We recorded foreign currency transaction losses and other expense of zero in the third quarter of 2006, compared with foreign currency transaction gains and other income of $0.1 million in the third quarter of 2005. In the first nine months of 2006, foreign currency transaction losses and other expense were $0.1 million, compared with foreign currency transaction gains and other income of $1.5 million in the first nine months of 2005. Changes in currency valuation in both the third quarter and the first nine months of 2006 were primarily a result of exchange rate movements between the U.S. dollar and the euro. The gains in 2005 resulted primarily from the revaluation of dollar holdings in an entity where the euro is the functional currency.

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*Income Taxes*. In the three and nine months ended September 30, 2006, we recorded a provision for income taxes of $17,000 and $46,000 respectively, primarily resulting from taxes payable in foreign jurisdictions that are not offset by operating loss carryforwards.

We recorded a tax provision of $0.1 million in the third quarter of 2005, resulting in a provision for income taxes for the nine months ended September 30, 2005 of $0.1 million.

*Discontinued Operations.* On May 22, 2006, we completed the sale of substantially all the assets and some of the liabilities associated with our DTV solutions business to Kudelski S.A. Net revenue for the DTV solutions business in the three and nine months ended September 30, 2006 was $1.9 million and $12.3 million, respectively. Net revenue for the DTV solutions business in the three and nine months ended September 30, 2005 was $5.3 million and $13.8 million, respectively. Operating loss for the DTV solutions business for the three and nine months ended September 30, 2006 was $0.1 million and $1.3 million, respectively. Operating results for the DTV solutions business for the three and nine months ended September 30, 2005 were a $0.1 million gain and a $2.5 million loss, respectively.

During 2003, we completed two transactions to sell our retail Digital Media and Video business. On July 25, 2003, we completed the sale of our digital video business to Pinnacle Systems and on August 1, 2003, we completed the sale of our retail digital media reader business to Zio Corporation. Net revenue for the retail Digital Media and Video business was $0 in each of the three- and nine-month periods ended September 30, 2006 and 2005. Operating loss for the Digital Media and Video business was $0.1 million and $0.2 million, respectively, in the three and nine months ended September 30, 2006, and operating loss was $0.1 million and $0.2 million, respectively, in the three and nine months ended September 30, 2005.

During the three and nine months ended September 30, 2006, net gain on the disposal of discontinued operations was approximately $24,000 and $5.3 million, respectively. During the three and nine months ended September 30, 2005, net loss on the disposal of discontinued operations was $0.1 million and 0.1 million, respectively.

**Liquidity and Capital Resources**

As of September 30, 2006 our working capital, which we have defined as current assets less current liabilities, was $29.7 million, compared to $27.4 million as of December 31, 2005, an increase of approximately $2.3 million. The increase in working capital for the first nine months of 2006 primarily reflects an increase in cash and cash equivalents, restricted short-term investments and short-term investments of $5.8 million and decreases in current liabilities of $2.0 million, offset by a decrease in accounts receivables, inventory and other current assets of $5.6 million.

Cash and cash equivalents, restricted short-term investments and short-term investments were $38.3 million as of September 30, 2006, an increase of nearly $6 million compared to the balance of $32.4 million as of December 31, 2005.

The following summarizes our cash flows for the nine months ended September 30, 2006 (in thousands):

| | | Nine Months Ended September 30, 2006 |
|---|---|---|
| Operating cash used in continuing operations | $ | (11,078) |
| Operating cash provided by discontinued operations | | 13,074 |
| Investing activity cash provided by continuing operations | | 9,460 |
| Investing activity cash provided by discontinued operations | | 3,484 |
| Financing cash flow | | 174 |
| Effect of exchange rate changes on cash and cash equivalents | | 187 |
| Increase in cash and cash equivalents | | 15,301 |

| | | |
|---|---|---|
| Cash and cash equivalents at beginning of period | | 13,660 |
| Cash and cash equivalents at end of period | $ | 28,961 |

During the first nine months of 2006, cash used in operating activities was $11.1 million and reflects a net loss from continuing operations of $8.4 million. The primary working capital use of cash was a decrease in accrued expenses and an increase in the other current assets.

In connection with our decision to transfer all manufacturing operations from our Singapore facility to contract manufacturers, we have provided a $2 million time deposit with a financial institution, which was restricted as to use and

represented compensating balances for a bank guarantee for the benefit of inventory purchases by a contract manufacturing supplier. This balance is included in restricted short-term investment on the balance sheet.

Significant commitments that will require the use of cash in future periods include obligations under operating leases, inventory purchase commitments and other contractual agreements. Gross committed lease obligations were approximately $6.3 million and inventory and other purchase commitments were approximately $6.0 million, of which approximately $1.7 million relate to the sold DTV solutions business.

In the coming months, we expect to continue to use cash to fund operations and we expect that our current capital resources will be sufficient to meet our operating and capital requirements for the next twelve months. We may, however, seek additional debt or equity financing prior to that time. There can be no assurance that additional capital will be available to us on favorable terms or at all. The sale of additional debt or equity securities may cause dilution to existing stockholders.

Cash provided by discontinued operations consisted primarily of the $9 million received in the sale of the DTV solutions business as well as the $4.7 million received from Aston for a VAT Refund (see Note 12 Legal Proceedings, for further discussion of this transaction).

Cash provided by investing activities was primarily for maturities of short-term investments of $14.4 million offset by additional purchases of $4.9 million.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There has been no significant change in our exposure to market risk during the first nine months of 2006. For discussion of our exposure to market risk, refer to Item 7A, Quantitative and Qualitative Disclosures About Market Risk, contained in our Annual Report incorporated by reference in Form 10-K for the year ended December 31, 2005.

**Item 4. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of September 30, 2006. We believe that our disclosure controls and procedures were effective as of September 30, 2006, such that the information relating to our business and operations, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls

In connection with our continued monitoring and maintenance of our controls procedures in relation to the provisions of the Sarbanes-Oxley Act of 2002, we continue to review, revise and improve the effectiveness of our internal controls. We made no changes to our internal control over financial reporting during the third quarter of 2006 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

**PART II: OTHER INFORMATION**

**Item 1. Legal Proceedings**

In December 2005, a complaint was filed in France against SCM Microsystems GmbH, one of our wholly-owned subsidiaries, by Aston France S.A., a competitor of ours in the former DTV solutions business conditional access modules market, alleging participation by SCM Microsystems GmbH in the counterfeiting of Aston s conditional access modules. Aston was one of our digital television customers until November 2002, when we entered into a settlement agreement (the 2002 Settlement ) with Aston that included our agreement to cancel binding orders made by Aston and the return by Aston of unsold inventory to us. In April 2005, we entered into an agreement with Aston whereby Aston agreed to (i) seek a refund from the French government for approximately $4.7 million in value added taxes that we paid to the French government with respect to products that Aston purchased from us prior to November 2002 and (ii) remit the refunded amount to us. On October 13, 2005 the French government refunded approximately $4.7 million (the VAT Refund ) to Aston, but Aston did not remit such amount to us. Shortly thereafter, Aston filed the action described above.

In its complaint filed in France, Aston claims damages in the amount of approximately $69 million. We believe, however, that the allegations made by Aston in their complaint are in contradiction to the statements made by Aston as part of the 2002 Settlement. On February 2, 2006, we filed a counterclaim against Aston in Germany alleging damages in the amount of approximately $14 million resulting from Aston s fraudulent misrepresentation and breach of contract in connection with the 2002 Settlement. Aston filed its response to our counterclaim on July 28, 2006. We replied on September 18, 2006 and expect a first court hearing to be scheduled soon.

In November 2005, Aston obtained a preliminary injunction in France to stay our claim for recovery of the VAT Refund and on February 21, 2006, the court that issued the injunction revised its order such that only approximately $1.2 million of the VAT Refund amount was still covered by the injunction. Both we and Aston appealed against this order. On June 1, 2006, a French appeals court released the injunction with respect to the entire amount of the VAT Refund and this decision has become final. Thereafter, we were able to enforce our claim for the VAT Refund and obtain a seizure of considerable amounts of Aston s assets. Subsequently, on June 12, 2006, Aston paid to us the full VAT Refund, including currency gains, in an amount of approximately

$5.0 million. We are currently attempting to enforce a contractual penalty payment under the April 2005 agreement relating to the VAT Refund and to obtain interest on the amount of the VAT Refund for late payment

We believe that the claims made by Aston in its complaint and in the preliminary injunction in France are without merit and were for the sole purpose of preventing or delaying our recovery of the VAT Refund. We intend to vigorously defend ourselves against the claims made by Aston and prosecute our counterclaims against Aston. Such efforts, however, may result in the incurrence of significant expense and cost and demand significant use of our management s limited time and resources. We can not assure you that we will be successful in defending ourselves against Aston s claims or in prosecuting our counterclaim against Aston, in each case, in a timely manner, in full or at all. If these claims are decided against us, the result may have a material and adverse effect on our company.

From time to time, we could be subject to other claims arising in the ordinary course of our business or could be a defendant in other lawsuits. While the outcome of such claims or other proceedings can not be predicted with certainty, our management currently expects that any such liabilities, to the extent not provided for by insurance or otherwise, will not have a material adverse effect on our financial condition, results of operations or cash flows.

## Item 1A. Risk Factors

*Our business and results of operations are subject to numerous risks, uncertainties and other factors that you should be aware of, some of which are described below. The risks, uncertainties and other factors described below are not the only ones facing our company. Additional risks, uncertainties and other factors not presently known to us or that we currently deem immaterial may also impair our business operations.*

*Any of the risk, uncertainties and other factors could have a materially adverse effect on our business, financial condition, results of operations, cash flows or product market share and could cause the trading price of our common stock to decline substantially.*

***We have incurred operating losses and may not achieve profitability.***

We have a history of losses with an accumulated deficit of $193.0 million as of September 30, 2006. We may continue to incur losses in the future and may be unable to achieve or maintain profitability.

***Our quarterly operating results will likely fluctuate.***

Our quarterly operating results have varied greatly in the past and will likely vary greatly in the future depending upon a number of factors. Many of these factors are beyond our control. Our revenues, gross profit and operating results may fluctuate significantly from quarter to quarter due to, among other things:

- business and economic conditions overall and in our markets;
- the timing and amount of orders we receive from our customers that may be tied to budgetary cycles, product plans, seasonal demand or equipment roll-out schedules;
- cancellations or delays of customer product orders, or the loss of a significant customer;
- our backlog and inventory levels;
- our customer and distributor inventory levels and product returns;
- competition;
- new product announcements or introductions;
- our ability to develop, introduce and market new products and product enhancements on a timely basis, if at all;
- our ability to successfully market and sell products into new geographic or customer market segments;
- the sales volume, product configuration and mix of products that we sell;

technological changes in the markets for our products;

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- reductions in the average selling prices that we are able to charge due to competition or other factors;
- strategic acquisitions, sales and dispositions;
- fluctuations in the value of foreign currencies against the U.S. dollar;
- the timing and amount of marketing and research and development expenditures;
- loss of key personnel; and
- costs related to events such as dispositions, organizational restructuring, headcount reductions, litigation or write-off of investments.

Due to these and other factors, our revenues may not increase or even remain at their current levels. Because a majority of our operating expenses are fixed, a small variation in our revenues can cause significant variations in our operational results from quarter to quarter and our operating results may vary significantly in future periods. Therefore, our historical results may not be a reliable indicator of our future performance.

***It is difficult to estimate operating results prior to the end of a quarter.***

We do not typically maintain a significant level of backlog. As a result, revenue in any quarter depends on contracts entered into or orders booked and shipped in that quarter. Historically, many of our customers have tended to make a significant portion of their purchases towards the end of the quarter, in part because they believe they are able to negotiate lower prices and more favorable terms. This trend makes predicting revenues difficult. The timing of closing larger orders increases the risk of quarter-to-quarter fluctuation in revenues. If orders forecasted for a specific group of customers for a particular quarter are not realized or revenues are not otherwise recognized in that quarter, our operating results for that quarter could be materially adversely affected. In addition, from time to time, we may experience unexpected increases in demand for our products resulting from seasonal demand in our customers markets. These occurrences are not always predictable and can have a significant impact on our results in the period in which they occur.

***Our strategy to grow revenue and become profitable depends in part on our ability to identify and secure new customers.***

We have adopted a strategy to accelerate the growth of our revenue that is in part based on introducing new PC Security and Flash Media Interface products that address new market opportunities. To date, this strategy has been only partially successful. Our target markets have not grown or developed as quickly as we had expected, and we have experienced delays in the development of new products designed to take advantage of new market opportunities. Since new target markets are still evolving, it is difficult to assess the competitive environment or the size of the market that may develop. If our target markets do not develop and create demand for our products, if we are not able to complete, sell and ship new products into the new markets we have identified, or if we are not able to compete against new or existing competitors in those markets, we may not be able to counter our revenue decline and our losses could increase.

***Our listing on both the NASDAQ Stock Market and the Prime Standard of the Frankfurt Stock Exchange exposes our stock price to additional risks of fluctuation.***

Our common stock is listed both on the NASDAQ Stock Market and the Prime Standard of the Frankfurt Stock Exchange and we typically experience a significant volume of our trading on the Prime Standard. Because of this, factors that would not otherwise affect a stock traded solely on the NASDAQ Stock Market may cause our stock price to fluctuate. For example, European investors may react differently and more positively or negatively than investors in the United States to events such as acquisitions, dispositions, one-time charges and higher or lower than expected revenue or earnings announcements. A positive or negative reaction by investors in Europe to such events could cause our stock price to increase or decrease significantly. The European economy and market conditions in general, or downturns on the Prime Standard specifically, regardless of the NASDAQ Stock Market conditions, also could negatively impact our stock price.

***Our stock price has been and is likely to remain volatile.***

Over the past few years, the NASDAQ Stock Market and the Prime Standard of the Frankfurt Exchange have experienced significant price and volume fluctuations that have particularly affected the market prices of the stocks of technology companies. Volatility in our stock price on either or both exchanges may result from a number of factors, including, among others:

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- variations in our or our competitors financial and/or operational results;
- the fluctuation in market value of comparable companies in any of our markets;
- expected, perceived or announced relationships or transactions with third parties;
- comments and forecasts by securities analysts;
- trading patterns of our stock on the NASDAQ Stock Market or Prime Standard of the Frankfurt Stock Exchange;
- the inclusion or removal of our stock from market indices, such as groups of technology stocks or other indices;
- loss of key personnel;
- announcements of technological innovations or new products by us or our competitors;
- announcements of dispositions, organizational restructuring, headcount reductions, litigation or write-off of investments;
- litigation developments; and
- general market downturns.

In the past, companies that have experienced volatility in the market price of their stock have been the object of securities class action litigation. If we were the object of securities class action litigation, it could result in substantial costs and a diversion of our management s attention and resources.

***A significant portion of our sales typically comes from a small number of customers and the loss of one or more of these customers or variability in the timing of orders could negatively impact our operating results.***

Our products are generally targeted at OEM customers in the consumer electronics, digital photography and computer industries, as well as the government sector and corporate enterprises. Sales to a relatively small number of customers historically have accounted for a significant percentage of our total revenues. For example, two customers accounted for approximately 26% of our total net revenue in the year ended December 31, 2005 and two customers accounted for approximately 27% of our total net revenue in the third quarter of 2006. We expect that sales of our products to a relatively small number of customers will continue to account for a high percentage of our total sales for the foreseeable future, particularly in our Flash Media Interface business. The loss of a customer or reduction of orders from a significant customer, including those due to product performance issues, changes in customer buying patterns, or market, economic or competitive conditions in our market segments, would increase our dependence on a smaller group of our remaining customers. Likewise, variations in the timing or patterns of customer orders could also increase our dependence on other customers in any particular period. Dependence on a small number of customers and variations in order levels period to period could result in decreased revenues, decreased margins, and/or inventory or receivables write-offs and otherwise harm our business and operating results.

***Sales of our products depend on the development of several emerging markets.***

We sell our products primarily to emerging markets that have not yet reached a stage of mass adoption or deployment. If demand for products in these markets does not develop further and grow sufficiently, our revenue and gross profit margins could decline or fail to grow. We cannot predict the future growth rate, if any, or size or composition of the market for any of our products. The demand and market acceptance for our products, as is common for new technologies, is subject to high levels of uncertainty and risk and may be influenced by various factors, including, but not limited to, the following:

- general economic conditions;

the ability of our competitors to develop and market competitive solutions in emerging markets and our ability to win business in advance of and against such competition;

the adoption and/or continuation of industry or government regulations or policies requiring the use of products such as our smart card readers;

the timing of adoption of smart cards by the U.S. and other governments, European banks and other enterprises for large scale security programs beyond those in place today;

the ability of financial institutions, corporate enterprises and the U.S. government to agree on industry specifications and to develop and deploy smart card-based applications that will drive demand for smart card readers such as ours; and

the ability of high capacity flash memory cards to drive demand for digital media readers, such as ours, that enable rapid transfer of large amounts of data, for example digital photographs.

***Our products may have defects, which could damage our reputation, decrease market acceptance of our products, cause us to lose customers and revenue and result in costly litigation or liability.***

Products such as our smart card readers and digital media readers may contain defects for many reasons, including defective design, defective material or software interoperability issues. Often, these defects are not detected until after the products have been shipped. If any of our products contain defects or perceived defects or have reliability, quality or compatibility problems or perceived problems, our reputation might be damaged significantly, we could lose or experience a delay in market acceptance of the affected product or products and we might be unable to retain existing customers or attract new customers. In addition, these defects could interrupt or delay sales or our ability to recognize revenue for products shipped. In the event of an actual or perceived defect or other problem, we may need to invest significant capital, technical, managerial and other resources to investigate and correct the potential defect or problem and potentially divert these resources from other development efforts. If we are unable to provide a solution to the potential defect or problem that is acceptable to our customers, we may be required to incur substantial product recall, repair and replacement and even litigation costs. These costs could have a material adverse effect on our business and operating results.

In addition, because our customers rely on our PC Security products to prevent unauthorized access to PCs, networks or facilities, a malfunction of or design defect in our products (or even a perceived defect) could result in legal or warranty claims against us for damages resulting from security breaches. If such claims are adversely decided against us, the potential liability could be substantial and have a material adverse effect on our business and operating results. Furthermore, the publicity associated with any such claim, whether or not decided against us, could adversely affect our reputation. In addition, a well-publicized security breach involving smart card-based and other security systems could adversely affect the market s perception of products like ours in general, or our products in particular, regardless of whether the breach is actual or attributable to our products. Any of the foregoing events could cause demand for our products to decline, which would cause our business and operating results to suffer.

***If we do not accurately anticipate the correct mix of products that will be sold, we may be required to record charges related to excess inventories.***

Due to the unpredictable nature of the demand for our products, we are required to place orders with our suppliers for components, finished products and services in advance of actual customer commitments to purchase these products. Significant unanticipated fluctuations in demand could result in costly excess production or inventories. In order to minimize the negative financial impact of excess production, we may be required to significantly reduce the sales price of the product to increase demand, which in turn could result in a reduction in the value of the original inventory purchase. If we were to determine that we could not utilize or sell this inventory, we may be required to write down its value, which we have done in the past. Writing down inventory or reducing product prices could adversely impact our cost of revenues and financial condition.

***Our business could suffer if our third-party manufacturers cannot meet production requirements.***

Our products are manufactured outside the United States by contract manufacturers. Our reliance on foreign manufacturing poses a number of risks, including, but not limited to:

difficulties in staffing;

currency fluctuations;

potentially adverse tax consequences;

unexpected changes in regulatory requirements;

tariffs and other trade barriers;

political and economic instability;

lack of control over the manufacturing process and ultimately over the quality of our products;

late delivery of our products, whether because of limited access to our product components, transportation delays and interruptions, difficulties in staffing, or disruptions such as natural disasters;

capacity limitations of our manufacturers, particularly in the context of new large contracts for our products, whether because our manufacturers lack the required capacity or are unwilling to produce the quantities we desire; and

obsolescence of our hardware products at the end of the manufacturing cycle.

In the second half of 2005 we shifted all product and component manufacturing previously performed by our employees to contract manufacturers, while continuing to manage demand planning, procurement and other related activities within SCM. The exclusive use of contract manufacturing reduces the flexibility we have in our operations and requires us to exercise strong planning and management in order to ensure that our products are manufactured on schedule, to correct specifications and to a high standard of quality. If any of our contract manufacturers cannot meet our production requirements, we may be required to rely on other contract manufacturing sources or identify and qualify new contract manufacturers. Despite efforts to do so, we may be unable to identify or qualify new contract manufacturers in a timely manner or at all or with reasonable terms and these new manufacturers may not allocate sufficient capacity to us in order to meet our requirements. Any significant delay in our ability to obtain adequate supplies of our products from our current or alternative manufacturers would materially and adversely affect our business and operating results. In addition, if we are not successful at managing the contract manufacturing process, the quality of our products could be jeopardized or inventories could be too low or too high, which could result in damage to our reputation with our customers and in the marketplace, as well as possible write-offs of excess inventory.

***We have a limited number of suppliers of key components, and may experience difficulties in obtaining components for which there is significant demand.***

We rely upon a limited number of suppliers of several key components of our products, which may expose us to various risks including, without limitation, an inadequate supply of components, price increases, late deliveries and poor component quality. This could result in components not being available to us in a timely manner or at all, particularly if larger companies have ordered more significant volumes of those components, or in higher prices being charged for components. Disruption or termination of the supply of components or software used in our products could delay shipments of these products. These delays could have a material adverse effect on our business and operating results and could also damage relationships with current and prospective customers.

***Our future success will depend on our ability to keep pace with technological change and meet the needs of our target markets and customers.***

The markets for our products are characterized by rapidly changing technology and the need to meet market requirements and to differentiate our products through technological enhancements, and in some cases, price. Our customers needs change, new technologies are introduced into the market, and industry standards are still evolving. As a result, product life cycles are often short and difficult to predict, and frequently we must develop new products quickly in order to remain competitive in light of new market requirements. Rapid changes in technology, or the adoption of new industry standards, could render our existing products obsolete and unmarketable. If a product is deemed to be obsolete or unmarketable, then we might have to reduce revenue expectations or write down inventories for that product.

Our future success will depend upon our ability to enhance our current products and to develop and introduce new products with clearly differentiated benefits that address the increasingly sophisticated needs of our customers and that keep pace with technological developments, new competitive product offerings and emerging industry standards. We must be able to demonstrate that our products have features or functions that are clearly differentiated from existing or anticipated competitive offerings, or we may be unsuccessful in selling these products. In addition, in cases where we are selected to supply products based on features or capabilities that are still under development, we must be able to complete our product design and delivery process on a timely basis, or risk losing current and any future revenue from those products. In developing our products, we must collaborate closely with our customers,

suppliers and other strategic partners to ensure that critical development, marketing and distribution projects proceed in a coordinated manner. Also, this collaboration is important because these relationships increase our exposure to information necessary to anticipate trends and plan product development. If any of our current relationships terminate or otherwise deteriorate, or if we are unable to enter into future alliances that provide us with comparable insight into market trends, our product development and marketing efforts may be adversely affected, and we could lose sales. We expect that our product development efforts will continue to require substantial investments and we may not have sufficient resources to make the necessary investments.

In some cases, we depend upon partners who provide one or more components of the overall solution for a customer in conjunction with our products. If our partners do not adapt their products and technologies to new market or distribution requirements, or if their products do not work well, then we may not be able to sell our products into certain markets.

Because we operate in markets for which industry-wide standards have not yet been fully set, it is possible that any standards eventually adopted could prove disadvantageous to or incompatible with our business model and product lines. If any of the standards supported by us do not achieve or sustain market acceptance, our business and operating results would be materially and adversely affected.

***Our markets are highly competitive.***

The markets for our products are intensely competitive and characterized by rapidly changing technology. We believe that the principal competitive factors affecting the markets for our products include:

the extent to which products must support existing industry standards and provide interoperability;

the extent to which standards are widely adopted and product interoperability is required within industry segments;

the extent to which products are differentiated based on technical features, quality and reliability, ease of use, strength of distribution channels and price; and

the ability of suppliers to develop new products quickly to satisfy new market and customer requirements.

We currently experience competition from a number of companies in each of our target market segments and we believe that competition in our markets is likely to intensify as a result of anticipated increased demand for secure digital access products. We may not be successful in competing against offerings from other companies and could lose business as a result.

We also experience indirect competition from certain of our customers who currently offer alternative products or are expected to introduce competitive products in the future. For example, we sell our products to many OEMs who incorporate our products into their offerings or who resell our products in order to provide a more complete solution to their customers. If our OEM customers develop their own products to replace ours, this would result in a loss of sales to those customers, as well as increased competition for our products in the marketplace. In addition, these OEM customers could cancel outstanding orders for our products, which could cause us to write down inventory already designated for those customers. We may in the future face competition from these and other parties that develop digital data security products based upon approaches similar to or different from those employed by us. In addition, the market for digital information security and access control products may ultimately be dominated by approaches other than the approach marketed by us.

Many of our current and potential competitors have significantly greater financial, technical, marketing, purchasing and other resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies or standards and to changes in customer requirements. Our competitors may also be able to devote greater resources to the development, promotion and sale of products and may be able to deliver competitive products at a lower end user price. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Therefore, new competitors, or alliances among competitors, may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and loss of market share.

***Sales of our smart card readers to the U.S. government are impacted by uncertainty of timelines and budgetary allocations, as well as by the delay of standards for information technology (IT) projects.***

Historically, we have sold a significant proportion of our smart card reader products to the U.S. government and we anticipate that some portion of our future revenues will also come from this sector. The timing of U.S. government smart card projects is not always certain. For example, while the U.S. government has announced plans for several new smart card-based security projects, few have yet reached a stage of sustained high volume card or reader

deployment, in part due to delays in reaching agreement on specifications for a new federally mandated set of identity credentials. In addition, government expenditures on IT projects have varied in the past and we expect them to vary in the future. As a result of shifting priorities in the federal budget and in the Department of Homeland Security, U.S. government spending may be reallocated away from IT projects, such as smart card deployments. The slowing or delay of government projects for any reason could negatively impact our sales.

***We may have to take back unsold inventory from our customers.***

Although our contractual obligations to accept returned products from our distributors and OEM customers are limited, if demand is less than anticipated, these customers may ask that we accept returned products that they do not believe they can sell. We may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. While we have experienced few product returns to date, returns may increase beyond present levels in the future. Once these products have been returned, we may be required to take additional inventory reserves to reflect the decreased market value of slow-selling returned inventory, even if the products are in good working order.

***Large stock holdings outside the U.S. make it difficult for us to achieve quorum at stockholder meetings and this could restrict, delay or prevent our ability to implement future corporate actions, as well as have other effects, such as the delisting of our stock from the NASDAQ Stock Market.***

To achieve a quorum at a regular or special stockholder meeting, at least one-third of all shares of our stock entitled to vote must be present at such a meeting in person or by proxy. As of August 7, 2006, the record date for our 2006 Annual Meeting of Stockholders, more than two-thirds of our shares outstanding were held by retail stockholders in Germany, through German banks and brokers. Securities regulations and customs in Germany result in very few German banks and brokers providing our proxy materials to our stockholders in Germany and in very few German stockholders voting their shares even when they do receive such materials. In addition, the absence of a routine broker non-vote in Germany typically requires the stockholder to return the proxy card to us before the votes it represents can be counted for purposes of establishing a quorum.

We expect that a significant percentage of our shares will continue to be held by retail stockholders in Germany through German banks and brokers. As a result, it is difficult and costly for us, and requires considerable management resources, to achieve a quorum at annual and special meetings of our stockholders, if we are able to do so at all. For example, because of the large pool of shares in Germany that were not voted, we had to adjourn our 2006 Annual Meeting of Stockholders from its original date of October 6, 2006, until November 3, 2006, in order to solicit enough votes to achieve quorum. This resulted in additional cost and diversion of management resources from our operations. We cannot assure you that we will be successful in obtaining proxies from a sufficient number of our stockholders to constitute a quorum in the future. If we are unable to achieve a quorum at a future annual or special meeting of our stockholders, corporate actions requiring stockholder approval could be restricted, delayed or even prevented. These include, but are not limited to, actions and transactions that may be of benefit to our stockholders, part of our strategic plan or necessary for our corporate governance, such as corporate mergers, acquisitions, dispositions, sales or reorganizations, financings, stock incentive plans or the election of directors. Even if we are able to achieve a quorum for a particular meeting, some of these actions or transactions require the approval of a majority of the total number of our shares then outstanding, and we cannot assure you that we will be successful in obtaining such approval.

The future failure to hold an annual meeting of stockholders may result in our being out of compliance with Delaware law and the qualitative listing requirements of the NASDAQ Stock Market, each of which requires us to hold an annual meeting of our stockholders. Our inability to obtain a quorum at any such meeting may not be an adequate excuse for such failure. In accordance with Section 211 of the Delaware General Corporation Law, if there has been a failure to hold an annual meeting, the Court of Chancery may order a meeting to be held upon the application of any stockholder or director. Lack of compliance with the qualitative listing requirements of the NASDAQ Stock Market could result in the delisting of our common stock on the NASDAQ Stock Market. Either of these events would divert management s attention from our operations and would likely be costly and could also have an adverse effect on the trading price of our common stock.

***We have global operations, which require significant financial, managerial and administrative resources.***

Our business model includes the management of separate product lines that address disparate market opportunities that are geographically dispersed. While there is some shared technology across our products, each product line requires significant research and development effort to address the evolving needs of our customers and markets. To support our development and sales efforts, we maintain company offices and business operations in several locations around the world. Managing our various development, sales and administrative operations places a significant burden on our financial systems and has resulted in a level of operational spending that is

disproportionately high compared to our current revenue levels.

Operating in diverse geographic locations also imposes significant burdens on our managerial resources. In particular, our management must:

divert a significant amount of time and energy to manage employees and contractors from diverse cultural backgrounds and who speak different languages;

- travel between our different company offices;
- maintain sufficient internal financial controls in multiple geographic locations that may have different control environments;
- manage different product lines for different markets;
- manage our supply and distribution channels across different countries and business practices; and
- coordinate these efforts to produce an integrated business effort, focus and vision.

Any failure to effectively manage our operations globally could have a material adverse effect on our business and operating results.

***The restructuring of our business could result in significant cost and disruptions in our operations.***

Over the past several years, we have periodically made changes in our organizational structure in an effort to improve efficiencies in our business or otherwise strengthen our ability to operate competitively. Recently, we consolidated our global operations into fewer locations, including the closure or reduction of some facilities and the movement of our corporate finance and compliance functions from the U.S. to Germany. In the future, we may from time to time pursue additional restructurings of our businesses and operations. There is no assurance, however, that any such restructurings will yield the benefits we contemplate or any benefits at all. In fact, any restructuring is likely to require us to incur significant expense and cost, including in connection with severance payments to employees, lease write-offs or other facility reduction or closure costs. In addition, restructurings could have other negative consequences on our business and operations, including the following:

- the movement of critical business functions from one location to another, which could cause disruptions in our ability to adequately perform those functions;
- the loss of key personnel and their knowledge about our company, which could be difficult to replace; and
- changes in or failure to follow processes or procedures in our operations, which could cause disruption in our supply chain, delays in delivering new products and other issues that could result in our inability to fulfill our commitments to customers.

Any of the foregoing events could have a material and adverse effect on our business.

In addition, over the past several months we have consolidated our operations into fewer locations. This includes the outsourcing of our manufacturing activities and the closure of our Singapore facility; moving our corporate finance and compliance activities from the U.S. to Germany; and the transfer of our French office and workforce as part of the sale of our DTV solutions business. The consolidation of our business creates risks, including loss of knowledge about our business and operations, loss of focus on key processes and procedures, and a greater possibility for failing to follow processes and procedures as functions are transitioned and affected personnel are no longer employed by us. Any failure to effectively manage the ongoing effects of our business consolidation could have a material adverse effect on our business and operating results.

***We conduct a significant portion of our operations outside the United States. Economic, political, regulatory and other risks associated with international sales and operations could have an adverse effect on our results of operation.***

In addition to our corporate headquarters being located in Germany, we conduct a substantial portion of our business in Europe and Asia. Approximately 58% of our revenue for the twelve months ended December 31, 2005 and approximately 57% of revenue for the nine months ended September 30, 2006 were derived from customers located outside the United States. Because a significant number of our principal customers are located in other countries, we anticipate that international sales will continue to account for a substantial portion of our revenues. As a result, a significant portion of our sales and operations may continue to be subject to risks associated with foreign operations, any of which could impact our sales and/or our operational performance. These risks include, but are not limited to:

changes in foreign currency exchange rates;

changes in a specific country s or region s political or economic conditions and stability, particularly in emerging markets;

unexpected changes in foreign laws and regulatory requirements;

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- potentially adverse tax consequences;
- longer accounts receivable collection cycles;
- difficulty in managing widespread sales and manufacturing operations; and
- less effective protection of intellectual property.

***Fluctuations in the valuation of foreign currencies could result in currency transaction losses.***

A significant portion of our business is conducted in foreign currencies, principally the euro. Fluctuations in the value of foreign currencies relative to the U.S. dollar will continue to cause currency transaction gains and losses. We cannot predict the effect of exchange rate fluctuations upon future quarterly and annual operating results. We may experience currency losses in the future. To date, we have not adopted a hedging program to protect us from risks associated with foreign currency fluctuations.

***Our key personnel are critical to our business, and such key personnel may not remain with us in the future.***

We depend on the continued employment of our senior executive officers and other key management and technical personnel. If any of our key personnel were to leave and not be replaced with sufficiently qualified and experienced personnel, our business could be adversely affected.

We also believe that our future success will depend in large part on our ability to attract and retain highly qualified technical and management personnel. However, competition for such personnel is intense. We may not be able to retain our key technical and management employees or to attract, assimilate or retain other highly qualified technical and management personnel in the future.

Likewise, as a small, dual-traded company, we are challenged to identify, attract and retain experienced professionals with diverse skills and backgrounds who are qualified and willing to serve on our Board of Directors. The increased burden of regulatory compliance under the Sarbanes-Oxley Act of 2002 creates additional liability and exposure for directors and financial losses in our business and lack of growth in our stock price make it difficult for us to offer attractive director compensation packages. If we are not able to attract and retain qualified board members, our ability to practice a high a level of corporate governance could be impaired.

***We are subject to a lengthy sales cycle and additional delays could result in significant fluctuations in our quarterly operating results.***

Our initial sales cycle for a new customer usually takes a minimum of six to nine months. During this sales cycle, we may expend substantial financial and managerial resources with no assurance that a sale will ultimately result. The length of a new customer s sales cycle depends on a number of factors, many of which we may not be able to control. These factors include the customer s product and technical requirements and the level of competition we face for that customer s business. Any delays in the sales cycle for new customers could delay or reduce our receipt of new revenue and could cause us to expend more resources to obtain new customer wins. If we are unsuccessful in managing sales cycles, our business could be adversely affected.

***We face risks associated with strategic transactions.***

A component of our ongoing business strategy is to seek to buy businesses, products and technologies that complement or augment our existing businesses, products and technologies. We have in the past acquired or made, and from time to time in the future may acquire or make, investments in companies, products and technologies that we believe are complementary to our existing businesses, products and technologies. Any future acquisition could expose us to significant risks, including, without limitation, the use of our limited cash balances or potentially dilutive stock offerings to fund such acquisitions; costs of any necessary financing, which may not be available on reasonable terms or at all; accounting charges we might incur in connection with such acquisitions; the difficulty and expense of integrating personnel, technologies, customer, supplier and distributor relationships, marketing efforts and facilities acquired through acquisitions; diversion of our management resources; failure to realize anticipated benefits; costly fees for legal and transaction-related services and the unanticipated assumption of liabilities. Any of the foregoing could have a material adverse effect on our financial condition and results of operations. We cannot assure you that any such acquisition will be successful.

Our business strategy also contemplates divesting portions of our business from time to time, if and when we believe we would be able to realize greater value for our stockholders in so doing. We have in the past sold, and may from time to time in the

future sell, all or one or more portions of our business. For example, on May 22, 2006, we completed the sale of our DTV solutions business to Kudelski. Any divestiture or disposition could expose us to significant risks, including, without limitation, costly fees for legal and transaction-related services; diversion of management resources; loss of key personnel; and reduction in revenue. Further, we may be required to retain or indemnify the buyer against certain liabilities and obligations in connection with any such divestiture or disposition and we may also become subject to third party claims arising out of divestiture or disposition. In addition, any such divestiture or disposition could result in our recognition of an operating loss to the extent that the proceeds received by us in the divestiture or disposition are less than the book value of the assets sold. Regarding the sale of our DTV solutions business in particular, risks include our ability to collect the remaining $2 million in disputed payments for the business, which are based on the completion of certain development work by Kudelski, and our ability to improve operational efficiencies or reduce operating costs through the transfer of our DTV solutions business. Failure to overcome these risks could have a material adverse effect on our financial condition and results of operations.

***We may be exposed to risks of intellectual property infringement by third parties.***

Our success depends significantly upon our proprietary technology. We currently rely on a combination of patent, copyright and trademark laws, trade secrets, confidentiality agreements and contractual provisions to protect our proprietary rights, which afford only limited protection. Although we often seek to protect our proprietary technology through patents, it is possible that no new patents will be issued, that our proprietary products or technologies are not patentable or that any issued patent will fail to provide us with any competitive advantages.

There has been a great deal of litigation in the technology industry regarding intellectual property rights, and from time to time we may be required to use litigation to protect our proprietary technology. This may result in our incurring substantial costs and there is no assurance that we would be successful in any such litigation.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to use our proprietary information and software without authorization. In addition, the laws of some foreign countries do not protect proprietary and intellectual property rights to the same extent as do the laws of the United States. Because many of our products are sold and a significant portion of our business is conducted outside the United States, our exposure to intellectual property risks may be higher. Our means of protecting our proprietary and intellectual property rights may not be adequate. There is a risk that our competitors will independently develop similar technology, duplicate our products or design around patents or other intellectual property rights. If we are unsuccessful in protecting our intellectual property or our products or technologies are duplicated by others, our business could be harmed.

***Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.***

We prepare our financial statements to conform with generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the Financial Standards Accounting Board, the American Institute of Certified Public Accountants, the Securities and Exchange Commission and various other bodies formed to interpret and create appropriate accounting rules and policies. A change in those rules or policies could have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. For example, under the recently issued Financial Accounting Standard Board Statement No. 123(R), as of January 1, 2006 we were required to apply certain expense recognition provisions to share-based payments to employees using the fair value method. Adoption of SFAS 123R resulted in our recording stock option compensation expense of $0.5 million in the first nine months of 2006. Any other changes in accounting policies in the future may also result in significant accounting charges. See Note 2 to the Condensed Consolidated Financial Statements for the expense disclosures under SFAS No. 123R.

***We face costs and risks associated with maintaining effective internal controls over financial reporting.***

Under Section 302 of the Sarbanes-Oxley Act of 2002, on a quarterly basis our management is required to make certain certifications regarding our disclosure controls and internal controls over financial reporting. The process of maintaining and evaluating the effectiveness of these controls is expensive, time-consuming and requires significant attention from our management and staff. We have found material weakness in our internal controls in the past and we cannot be certain in the future that we will be able to report that our controls are without material weakness or to

complete our evaluation of those controls in a timely fashion.

If we fail to maintain an effective system of disclosure controls or internal control over financial reporting, we may discover material weaknesses that we would then be required to disclose. We may not be able to accurately or timely report on our financial results, and we might be subject to investigation by regulatory authorities. As a result, the financial position of our

business could be harmed; current and potential future shareholders could lose confidence in us and/or our reported financial results, which may cause a negative effect on the trading price of our common stock; and we could be exposed to litigation or regulatory proceedings, which may be costly or divert management attention.

In addition, all internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to the preparation and presentation of financial statements. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

***We face risks from litigation.***

From time to time, we may be subject to litigation, which could include claims regarding infringement of the intellectual property rights of third parties, product defects, employment-related claims, and claims related to acquisitions, dispositions or restructurings. Any claims or litigation may be time-consuming and costly, divert management resources, cause product shipment delays, require us to redesign our products, require us to accept return of product and to write off inventory, or have other adverse effects on our business. Any of the foregoing could have a material adverse effect on our results of operations and could require us to pay significant monetary damages.

For example, in December 2005, a complaint was filed in France against SCM Microsystems GmbH, one of our wholly-owned subsidiaries, by Aston France S.A. alleging participation by SCM Microsystems GmbH in the counterfeiting of Aston s conditional access modules and claiming damages in the amount of approximately $69 million. Our defense of such claim may result in our incurrence of significant expense and cost and demand significant use of our management s limited time and resources. We cannot assure you that we will be successful in defending ourselves against Aston s claims in a timely manner or at all. If these claims are decided against us, the result may have a material and adverse effect on our company.

We expect the likelihood of intellectual property infringement and misappropriation claims may increase as the number of products and competitors in our markets grows and as we increasingly incorporate third-party technology into our products. As a result of infringement claims, we could be required to license intellectual property from a third party or redesign our products. Licenses may not be offered when we need them or on acceptable terms. If we do obtain licenses from third parties, we may be required to pay license fees or royalty payments or we may be required to license some of our intellectual property to others in return for such licenses. If we are unable to obtain a license that is necessary for us or our third party manufacturers to manufacture our allegedly infringing products, we could be required to suspend the manufacture of products or stop our suppliers from using processes that may infringe the rights of third parties. We may also be unsuccessful in redesigning our products. Our suppliers and customers may be subject to infringement claims based on intellectual property included in our products. We have historically agreed to indemnify our suppliers and customers for patent infringement claims relating to our products. The scope of this indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorney s fees. We may periodically engage in litigation as a result of these indemnification obligations. Our insurance policies exclude coverage for third-party claims for patent infringement.

***We are exposed to credit risk on our accounts receivable. This risk is heightened in times of economic weakness.***

We distribute our products both through third-party resellers and directly to certain customers. A substantial majority of our outstanding trade receivables are not covered by collateral or credit insurance. While we seek to monitor and limit our exposure to credit risk on our trade and non-trade receivables, we may not be effective in limiting credit risk and avoiding losses. Additionally, if the global economy and regional economies deteriorate, one or more of our customers could experience a weakened financial condition and we could incur a material loss or losses as a result.

***Provisions in our agreements, charter documents, Delaware law and our rights plan may delay or prevent our acquisition by another company, which could decrease the value of your shares.***

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us or enter into a material transaction with us without the consent of our Board of Directors. These provisions include a classified Board of Directors and limitations on actions by our stockholders by written consent. Delaware law imposes some restrictions on mergers and other business combinations between us and

any holder of 15% or more of our outstanding common stock. In addition, our Board of Directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

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We have adopted a stockholder rights plan. The triggering and exercise of the rights would cause substantial dilution to a person or group that attempts to acquire us on terms or in a manner not approved by our Board of Directors, except pursuant to an offer conditioned upon redemption of the rights. While the rights are not intended to prevent a takeover of our company, they may have the effect of rendering more difficult or discouraging an acquisition of us that was deemed to be undesirable by our Board of Directors.

Although we believe the above provisions and the adoption of a rights plan may provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our Board of Directors, these provisions will apply even if the offer were to be considered adequate by some of our stockholders. Also, because these provisions may be deemed to discourage a change of control, they could decrease the value of our common stock.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None

**Item 3. Defaults upon Senior Securities.**

None

**Item 4. Submission of Matters to a Vote of Security Holders.**

Our 2006 Annual Meeting of Stockholders was originally scheduled for October 6, 2006 but was adjourned to November 3, 2006 to provide us with more time to achieve a quorum. At our adjourned Annual Meeting on November 3, 2006, the following matters were acted upon by the stockholders of the Company:

1. The election of Werner Koepf and Simon Turner as directors of the Company, each to hold office for a three-year term or until a successor is elected and qualified.

2. Ratification of the appointment of Deloitte & Touche LLP as independent auditors of the Company for the fiscal year ending December 31, 2006.

The number of shares of our common stock outstanding and entitled to vote at our 2006 Annual Meeting was 15,642,223 and 5,415,935 shares were represented in person or by proxy at the adjourned Annual Meeting on November 3, 2006, constituting a quorum, which is defined as one-third of shares eligible to vote. The results of the voting on each of the matters presented to stockholders at the Annual Meeting are set forth below:

| | Votes For | Votes Abstained/Withheld |
|---|---|---|
| 1. Election of Directors | | |
| o *Werner Koepf* | 5,392,289 | 23,646 |
| o *Simon Turner* | 4,971,344 | 444,591 |

| | Votes For | Votes Against | Votes Abstained/Withheld |
|---|---|---|---|
| 2. Ratification of Independent Auditors | 5,391,263 | 8,766 | 15,906 |

**Item 5. Other Information.**

None.

**Item 6. Exhibits**

(a) Exhibits.

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| Exhibit Number | Description of Document |
|---|---|
| 31.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32 | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

| | |
|---|---|
| | Registrant |
| | SCM MICROSYSTEMS, INC. |
| November 14, 2006 | By: /s/ Robert Schneider |
| | Robert Schneider<br>Chief Executive Officer |
| November 14, 2006 | /s/ Stephan Rohaly |
| | Stephan Rohaly<br>Chief Financial Officer |

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## EXHIBIT INDEX

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