SCM MICROSYSTEMS INC
Form 10-Q
August 12, 2008

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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 JUNE 30, 2008
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)

Oskar-Messter-Str. 13, 85737 Ismaning, Germany
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES INCLUDING ZIP CODE)
+ 49 89 95 95 5000
(REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE)
(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, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o	Smaller reporting company þ

(Do not check if a smaller reporting company)
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 August 5, 2008, 15,743,515 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 June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net revenue	$ 6,520	$ 4,647	$ 12,984	$ 13,104
Cost of revenue	3,697	3,314	7,478	8,031
Gross profit	2,823	1,333	5,506	5,073
Operating expenses:				
Research and development	1,043	792	2,078	1,512
Selling and marketing	2,569	1,618	4,730	3,177
General and administrative	1,518	2,879	3,021	4,279
Amortization of intangible assets	0	97	0	272
Total operating expenses	5,130	5,386	9,829	9,240
Loss from operations	(2,307)	(4,053)	(4,323)	(4,167)
Interest and other income, net	330	412	824	720
Loss from continuing operations before income taxes	(1,977)	(3,641)	(3,499)	(3,447)
Provision for income taxes	(1)	(32)	(48)	(92)
Loss from continuing operations	(1,978)	(3,673)	(3,547)	(3,539)
Loss from discontinued operations, net of income taxes	(26)	(102)	(151)	(119)
Gain on sale of discontinued operations, net of income taxes	496	1,530	509	1,553
Net loss	$ (1,508)	$ (2,245)	$ (3,189)	$ (2,105)
Loss per share from continuing operations:				
Basic and diluted	$ (0.13)	$ (0.23)	$ (0.22)	$ (0.23)
Gain per share from discontinued operations:				
Basic and diluted	$ 0.03	$ 0.09	$ 0.02	$ 0.09
Net loss per share:				
Basic and diluted	$ (0.10)	$ (0.14)	$ (0.20)	$ (0.14)
Shares used to compute basic and diluted income (loss) per share	15,744	15,730	15,742	15,715
Comprehensive loss:				

Net loss	$ (1,508)	$ (2,245)	$ (3,189)	$ (2,105)
Unrealized gain (loss) on investments	(5)	(1)	28	10
Foreign currency translation adjustment	(516)	306	(179)	534
Total comprehensive loss	$ (2,029)	$ (1,940)	$ (3,340)	$ (1,561)

See notes to condensed consolidated financial statements.

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

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,991	$ 18,600
Short-term investments	0	13,844
Accounts receivable, net of allowances of $443 and $341 as of June 30, 2008 and December 31, 2007, respectively	7,228	8,638
Inventories	4,108	2,738
Other current assets	1,483	1,455
Total current assets	40,810	45,275
Property and equipment, net	1,431	1,522
Other assets	1,884	1,767
Total assets	$ 44,125	$ 48,564
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,733	$ 3,063
Accrued compensation and related benefits	1,528	1,213
Accrued restructuring and other charges	1,877	2,960
Accrued professional fees	869	993
Accrued royalties	408	417
Other accrued expenses	2,314	2,325
Income taxes payable	340	277
Total current liabilities	10,069	11,248
Deferred tax liability	81	77
Long-term income taxes payable	133	200
Commitments and contingencies (see Notes 10 and 11)		
Stockholders equity:		
Common stock, $0.001 par value: 40,000 shares authorized; 16,362 and 16,356 shares issued and 15,744 and 15,737 shares outstanding as of June 30, 2008 and December 31, 2007, respectively	16	16
Additional paid-in capital	229,557	229,414
Treasury stock, 618 shares	(2,777)	(2,777)
Accumulated deficit	(195,278)	(192,089)
Accumulated other comprehensive income	2,324	2,475
Total stockholders equity	33,842	37,039

Total liabilities and stockholders equity	$ 44,125	$ 48,564

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)

	Six Months Ended June 30,	
	2008	**2007**
Cash flows from operating activities:		
Net loss	$ (3,189)	$ (2,105)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Gain from discontinued operations	(358)	(1,434)
Depreciation and amortization	152	416
Loss (gain) on disposal of fixed assets		(6)
Stock compensation expense	125	407
Deferred income taxes	4	9
Changes in operating assets and liabilities:		
Accounts receivable	1,265	2,148
Inventories	(1,396)	(1,919)
Other assets	(131)	859
Accounts payable	(217)	(1,430)
Accrued expenses	174	(985)
Income taxes payable	(21)	43
Net cash used in operating activities from continuing operations	(3,592)	(3,997)
Net cash provided by (used in) operating activities from discontinued operations	(664)	1,190
Net cash used in operating activities	(4,256)	(2,807)
Cash flows from investing activities:		
Capital expenditures	(159)	(164)
Maturities of short-term investments	13,873	7,699
Purchases of short-term investments		(8,862)
Net cash provided by (used in) investing activities	13,714	(1,327)
Cash flows from financing activities:		
Proceeds from issuance of equity securities, net	18	104
Net cash provided by financing activities	18	104
Effect of exchange rates on cash and cash equivalents	(85)	443
Net increase (decrease) in cash and cash equivalents	9,391	(3,587)
Cash and cash equivalents at beginning of period	18,600	32,103
Cash and cash equivalents at end of period	$ 27,991	$ 28,516

Supplemental disclosures of cash flow information:		
Income taxes paid	$ 51	$ 45
Property and equipment invoices in accounts payable	$ 24	$ 6

See notes to condensed consolidated financial statements.

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SCM MICROSYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2008

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 (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation 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 of our financial position, results of operations and cash flows have been included. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008 or any future period. For further information, refer to the financial statements and notes thereto included in SCM Microsystems, Inc. s (SCM or the Company) Annual Report on Form 10-K for the year ended December 31, 2007. The preparation of our unaudited condensed consolidated financial statements necessarily requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented.

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 a total consideration of $10.6 million in cash, of which $9.0 million was paid at the time of sale and $1.6 million was paid in May 2007.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and six months ended June 30, 2008 and 2007, 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.

Recent Accounting Pronouncements and Accounting Changes

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)). Under SFAS No. 141(R), an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred, restructuring costs generally be expensed in periods subsequent to the acquisition date, and changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be included in income tax expense. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. The adoption of SFAS No. 141(R) will change the Company s accounting treatment for business combinations on a prospective basis beginning in the first quarter of fiscal year 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. SFAS No. 160 changes the accounting and reporting for minority interests, which will be recharacterized as non-controlling interests and classified as a component of equity. SFAS No. 160 is effective for us on a prospective basis for business combinations with an acquisition date beginning in the first quarter of fiscal year 2009. As of June 30, 2008, SCM did not have any minority interests.

On January 1, 2008, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits companies to choose to measure certain financial instruments and other items at fair value using an instrument-by-instrument election. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. The adoption of SFAS No. 159 did not have an impact on SCM s consolidated financial position, results of operations or cash flows.

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On January 1, 2008, SCM adopted SFAS No. 157, *Fair Value Measurements*, for all financial assets and financial liabilities and for all non-financial assets and non-financial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis (i.e., at least annually). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. SFAS No. 157 does not change the accounting for those instruments that were, under previous GAAP, accounted for at cost or contract value. The adoption of SFAS No. 157 did not have a significant impact on the Company s consolidated financial statements, and the resulting fair values calculated under SFAS No. 157 after adoption were not significantly different than the fair values that would have been calculated under previous guidance.

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable objective inputs and minimize the use of unobservable inputs, which require additional reliance on the Company s judgment, when measuring fair value. A financial instrument s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. SFAS No. 157 establishes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices for identical instruments in active markets;

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-derived valuations, in which all significant inputs are observable in active markets; and

Level 3 Valuations derived from valuation techniques, in which one or more significant inputs are unobservable.

The Company uses the following classifications to measure different financial instruments at fair value, including an indication of the level in the fair value hierarchy in which each instrument is generally classified:

Cash equivalents include highly liquid debt investments (money market fund deposits and commercial papers) with maturities of three months or less at the date of acquisition. These financial instruments are classified in Level 1 of the fair value hierarchy.

Short term investments consist of corporate notes and United States government agency instruments and are classified as available-for-sale. These financial instruments are classified in Level 1 of the fair value hierarchy. As of June 30, 2008, the Company has no short term investments.

Assets that are measured and recognized at fair value on a recurring basis classified under the appropriate level of the fair value hierarchy as of June 30, 2008 were as follows (in thousands):

	Level 1	Level 2	Level 3	Total
Money market fund deposits	$ 16,168	$	$	$ 16,168
Commercial papers	5,967			5,967
Total:	$ 22,135	$	$	$ 22,135

As of June 30, 2008, there are no liabilities that are measured and recognized at fair value on a recurring basis.

In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements that Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, (FSP 157-1) and FSP 157-2, *Effective Date of FASB Statement No. 157*. FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. The Company is currently evaluating the impact that SFAS No. 157 will have on its consolidated financial statements when it is applied to non-financial assets and non-financial liabilities that are not measured at fair value on a recurring basis beginning in the first quarter of 2009.

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

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majority of which are stockholder approved. Stock options are generally time-based and expire seven to ten years from the date of grant. Vesting varies, with some options vesting 25% each year over four years; some vesting 1/12th per month over one year; some vesting 100% after one year; and some vesting 1/12th per month, commencing four years from the date of grant.

The Company previously had an Employee Stock Purchase Plan (ESPP) that allowed 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 purchases under the Company s ESPP were newly issued shares. The Company s ESPP, Director Option Plan and 1997 Stock Option Plan all expired in March 2007. In November 2007, stockholders approved the 2007 Stock Option Plan, which authorizes the issuance of up to 1.5 million shares of the Company s common stock pursuant to stock option grants.

As of June 30, 2008, an aggregate of approximately 3.1 million shares of the Company s common stock was reserved for future issuance under the Company s stock option plans, of which 2.0 million shares were subject to outstanding options.

In calculating stock-based 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.

The following table illustrates the stock-based compensation expense resulting from stock options and shares issued under the ESPP included in the unaudited condensed consolidated statement of operations for the three and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Cost of revenue	$ (2)	$ 19	$ 10	$ 33
Research and development	6	22	25	45
Selling and marketing	6	70	62	100
General and administrative	37	167	28	229
Stock-based compensation expense before income taxes	$ 47	$ 278	$ 125	$ 407
Income tax benefit	0	0	0	0
Stock-based compensation expense after income taxes	$ 47	$ 278	$ 125	$ 407

Stock Option Plans

The Company s Director Option Plan and 1997 Stock Option Plan expired in March 2007, and options can no longer be granted under these plans. However, outstanding options granted under these plans remain exercisable in accordance with the terms of the original grant agreements.

In November 2007, stockholders approved the 2007 Stock Option Plan, which authorizes the issuance of up to 1.5 million shares of the Company s common stock pursuant to stock option grants. As of June 30, 2008, a total of 1,127,726 shares of the Company s common stock are reserved for future option grants under the 2000 Stock Option Plan and the 2007 Stock Option Plan, and 2.0 million shares were reserved for future issuance pursuant to outstanding options.

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A summary of the activity under the Company s stock option plans for the six months ended June 30, 2008 is as follows:

	Options Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price per share	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (in years)
Balance at December 31, 2007	1,493,493	1,862,272	$ 10.97	$ 191,809	5.77
Options granted	(506,171)	506,171	$ 3.12		
Options cancelled or expired	140,404	(392,480)	$ 17.62		
Options exercised		(6,250)	$ 2.93	$ 1,507	
Balance at June 30, 2008	1,127,726	1,969,713	$ 7.66	$ 26,147	5.99
Vested or expected to vest at June 30, 2008		1,769,443	$ 8.15	$ 24,552	5.84
Exerciseable at June 30, 2008		1,060,891	$ 11.42	$ 11,413	4.89

The weighted-average grant date fair value per option for options granted during the three and six months ended June 30, 2008 was $1.38 and $1.39, respectively. The weighted-average grant date fair value per option for options granted during the three and six months ended June 30, 2007 was $1.02 and $1.91, respectively. The total intrinsic value of options exercised during the three and six months ended June 30, 2008 was $0 and $1,500, respectively. The total intrinsic value of options exercised during the three and six months ended June 30, 2007 was $7,578 and $8,331, respectively. Cash proceeds from the exercise of stock options were $0 and $18,000 for the three and six months ended June 30, 2008, respectively. Cash proceeds from the exercise of stock options were $30,149 and $33,135 for the three and six months ended June 30, 2007, respectively. An income tax benefit of less than $1,000 was realized from stock option exercises during both the three and six months ended June 30, 2008. No income tax benefit was realized from stock option exercises during both the three and six months ended June 30, 2007. At June 30, 2008, there was $1.0 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 3.0 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 six months ended June 30, 2008 and 2007, respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Expected volatility	54%	57%	54%	58%
Dividend yield	0	0	0	0
Risk-free interest rate	3.13%	4.90%	2.64%	4.73%

Expected term (in years)	4.00	4.00	4.00	4.00

Expected Volatility: The Company s computation of expected volatility for both the three and six months ended June 30, 2008 is based on the historical volatility of the Company s stock for a time period equivalent to the expected term.

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 both the three and six months ended June 30, 2008 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.

Forfeitures Rate: Compensation expense recognized in the consolidated statement of operations for both the three and six months ended June 30, 2008 and 2007 is based on awards ultimately expected to vest and it reflects estimated forfeitures. FASB SFAS No. 123 revised 2004 (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.

1997 Employee Stock Purchase Plan

Until its expiration in March 2007, the Company s ESPP permitted eligible employees to purchase the Company s common stock through payroll deductions of up to 10% of their base wages at a purchase price of 85% of the lower of fair market value of the Company s common stock at the beginning or end of each offering period. The Company had a two-year rolling plan with four purchases every six months within the offering period. If the fair market value per share was lower on the purchase date than the beginning of the offering period, the current offering period terminated and a new two year offering period would have commenced. The Company s ESPP restricted the maximum amount of shares purchased by an individual to $25,000 worth of the Company s common stock each year. As of June 30, 2008, no shares were available for future issuance under the Company s ESPP, due to the plan s expiration in March 2007.

Stock-based compensation expense related to the Company s ESPP recognized under SFAS 123(R) for both the three months and six months ended June 30, 2008 was zero. Stock-based compensation expense related to the Company s ESPP recognized under SFAS 123(R) for the three and six months ended June 30, 2007 was zero and a benefit of $40,000, respectively. The benefit in the first six months of 2007 stemmed from the expiration of the plan before the expected offering periods had terminated. At June 30, 2008, there was no further unrecognized stock-based compensation expense related to outstanding ESPP shares as the plan expired in March 2007.

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 a total consideration of $10.6 million in cash, of which $9.0 million was paid at the time of sale and $1.6 million, which was paid in May 2007.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for both the three and six months ended June 30, 2008, the DTV solutions business has been presented as discontinued operations in the unaudited 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. An additional $1.5 million gain on sale of discontinued operations was realized in May 2007 primarily resulting from the final payment by Kudelski as described above.

Based on a Transition Services and Side Agreement between the Company and Kudelski, revenues relating to the discontinued operations of the DTV solutions business were generated for a limited time after the sale of the DTV solutions business. Under this agreement, a service fee was earned by the Company for its services related to ordering products from a supplier and selling these products to Kudelski. The agreement was terminated at the end of the first quarter of 2007 and related revenues ceased to be generated after that period.

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The operating results for the discontinued operations of the DTV solutions business for the three and six months ended June 30, 2008 and 2007 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net revenue	$	$	$	$496
Operating loss	$(2)	$(46)	$(6)	$ (12)
Income (loss) before income taxes	$(2)	$(46)	$(6)	$ 11
Income tax benefit (provision)	$	$(16)	$	$ (16)
Income (loss) from discontinued operations	$(2)	$(62)	$(6)	$ (5)

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 six months ended June 30, 2008 and 2007 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net revenue	$	$	$	$
Operating loss	$(62)	$(74)	$(144)	$(154)
Net loss before income taxes	$(22)	$(40)	$(140)	$(114)
Income tax provision	$ (2)	$	$ (5)	$
Loss from discontinued operations	$(24)	$(40)	$(145)	$(114)

In April 2008, the Company entered into an agreement to terminate its lease agreement for the premises leased in the UK, which resulted in approximately $0.4 million gain on sale of discontinued operations in the second quarter of 2008.

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4. Short-Term Investments

At June 30, 2008, the amount of short term investments was zero. The fair value of short-term investments at December 31, 2007 was as follows (in thousands):

	December 31, 2007			
	Amortized Cost	Unrealized Gain on Investments	Unrealized Loss on Investments	Estimated Fair Value
Corporate notes	$ 13,872	$	$ (28)	$ 13,844

The Company adopted SFAS No. 157 during the quarter ended March 31, 2008, see Note 1 Basis of Presentation for further discussion and explanation.

5. Inventories

Inventories consist of (in thousands):

	June 30, 2008	December 31, 2007
Raw materials	$ 1,405	$ 1,202
Finished goods	2,703	1,536
Total	$ 4,108	$ 2,738

6. Property and Equipment

Property and equipment consists of (in thousands):

	June 30, 2008	December 31, 2007
Land	$ 131	$ 142
Building and leasehold improvements	1,906	1,972
Furniture, fixtures and office equipment	3,200	3,223
Automobiles	32	35
Purchased software	3,628	3,526
Total	8,897	8,898
Accumulated depreciation	(7,466)	(7,376)
Property and equipment, net	$ 1,431	$ 1,522

Depreciation expense was $0.1 million and $0.2 million for the three and six months ended June 30, 2008, respectively, and $0.1 million and $0.1 million for the three and six months ended June 30, 2007, respectively.

7. Intangible Assets

Amortization expense related to intangible assets for continuing operations was zero for the three and six months ended June 30, 2008, and $0.1 million and $0.3 million for the three and six months ended June 30, 2007, respectively. No further amounts remain to be amortized in future periods.

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8. Restructuring and Other Charges

Continuing Operations

During the three- and six month periods ended June 30, 2008 and 2007, the Company incurred no restructuring and other charges related to continuing operations.

Accrued liabilities related to restructuring actions and other activities during the six months ended June 30, 2008 and during the year ended December 31, 2007 consist of the following (in thousands):

	Lease/Contract Commitments	Severance	Other Costs	Total
Balances as of January 1, 2007	$ 15	$ 106	$ 9	$ 130
Provision for 2007				
Changes in estimates		(4)		(4)
		(4)		(4)
Payments and other changes in 2007	(3)	(102)	1	(104)
Balances as of December 31, 2007	12		10	22
Provision for Q1 2008				
Changes in estimates				
Payments and other changes in Q1 2008				
Balances as of March 31, 2008	12		10	22
Provision for Q2 2008				
Changes in estimates				
	12		10	22
Payments and other changes in Q2 2008	(1)			(1)
Balances as of June 30, 2008	$ 11	$	$ 10	$ 21

Discontinued Operations

During the three and six months ended June 30, 2008, income from restructuring and other items related to discontinued operations was approximately $0.5 million, which related primarily to an agreement to terminate the lease for the premises leased in the UK in April 2008. A termination payment and related transaction costs of approximately $0.5 million were incurred and the related restructuring accruals of approximately $0.9 million were released. The transaction resulted in a net gain of approximately $0.4 million from discontinued operations.

During the three and six months ended June 30, 2007, income from restructuring and other items related to discontinued operations was approximately $63,000 and $76,000, respectively.

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Accrued liabilities related to the Digital Media and Video restructuring actions and other activities during the six months ended June 30, 2008 and during the year ended December 31, 2007 consist of the following (in thousands):

	Lease/Contract Commitments	Other Costs	Total
Balances as of January 1, 2007	$ 2,949	$ 352	$ 3,301
Provision for 2007			
Changes in estimates	(70)	(40)	(110)
	(70)	(40)	(110)
Payments and other changes in 2007	(290)	37	(253)
Balances as of December 31, 2007	2,589	349	2,938
Provision for Q1 2008			
Changes in estimates	(19)		(19)
	(19)		(19)
Payments and other changes in Q1 2008	(54)	26	(28)
Balances as of March 31, 2008	2,516	375	2,891
Provision for Q2 2008			
Changes in estimates	(494)		(494)
	(494)		(494)
Payments and other changes in Q2 2008	(539)	(2)	(541)
Balances as of June 30, 2008	$ 1,483	$ 373	$ 1,856

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; Executive Vice President, Strategic Sales and Business Development and Executive Vice President, Strategy, Marketing and Engineering.

The Company s continuing operations provide secure digital access solutions to original equipment manufacturers, or OEMs in two markets segments: PC Security and Digital Media Readers. 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 six months ended June 30, 2008 and 2007 is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
PC Security:				
Net revenue	$4,878	$3,864	$ 9,885	$10,960
Gross profit	2,276	1,256	$ 4,423	$ 4,499
Gross profit %	47%	33%	45%	41%
Digital Media Readers				
Net revenue	$1,642	$ 783	$ 3,099	$ 2,144
Gross profit	547	77	$ 1,083	$ 574
Gross profit %	33%	10%	35%	27%
Total:				
Net revenue	$6,520	$4,647	$12,984	$13,104
Gross profit	2,823	1,333	5,506	5,073
Gross profit %	43%	29%	42%	39%

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net revenue				
Europe	$ 2,697	$ 1,705	$ 5,087	$ 4,113
United States	2,449	2,140	4,560	5,939
Asia-Pacific	1,374	802	3,337	3,052
Total	$ 6,520	$ 4,647	$ 12,984	$ 13,104
% of net revenue				
Europe	41%	37%	39%	31%
United States	38%	46%	35%	46%
Asia-Pacific	21%	17%	26%	23%

Long-lived assets by geographic location as of June 30, 2008 and December 31, 2007, are as follows (in thousands):

	June 30, 2008	December 31, 2007
Property and equipment, net:		
United States	$ 9	$ 14
Europe	221	171
Asia-Pacific	1,201	1,337

Total	$ 1,431	$ 1,522

All of the long-lived assets as of June 30, 2008 and December 31, 2007, disclosed for Asia-Pacific, relate to our facilities in India.

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10. Commitments

The Company leases its facilities, certain equipment, and automobiles under noncancelable operating lease agreements. Those lease agreements existing as of June 30, 2008 expire at various dates during the next five years.

Purchases for inventories are highly dependent upon forecasts of customer 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 June 30, 2008, total purchase and contractual commitments due within one year were approximately $11.9 million, and additional purchase and contractual commitments due within two years were approximately $3.0 million.

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.

Components of the reserve for warranty costs for the six months ended June 30, 2008 and 2007 were as follows (in thousands):

	2008	2007
Balances at January 1	$ 36	$ 34
Additions related to sales during the period	26	31
Warranty costs incurred during the period	(13)	(27)
Adjustments to accruals related to prior period sales	(24)	(7)
Balances at June 30	$ 25	$ 31

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 June 30,		For the Six months Ended June 30,	
	2008	2007	2008	2007
Net loss from continuing operations	$ (1,978)	$ (3,673)	$ (3,547)	$ (3,539)
Income from discontinued operations	470	1,428	358	1,434
Net income (loss)	$ (1,508)	$ (2,245)	$ (3,189)	$ (2,105)
Weighted average common shares outstanding used in income (loss) per common share - basic and diluted	15,744	15,730	15,742	15,715
Net income (loss) per common share - basic and diluted				
Continuing operations	$ (0.13)	$ (0.23)	$ (0.22)	$ (0.23)
Discontinued operations	$ 0.03	$ 0.09	$ 0.02	$ 0.09

Net income (loss) per common share - basic and diluted	$	(0.10)	$	(0.14)	$	(0.20)	$	(0.14)

The computation of diluted net loss per common share for the three and six months ended June 30, 2008 excludes the effect of the potential exercise of options to purchase approximately 3,000 and 7,000 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 six months ended June 30, 2008 also excludes the effect of the potential exercise of options to purchase approximately 1.9 million and 1.8 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 income per common share for the three and six months ended June 30, 2007 excludes the effect of the potential exercise of options to purchase approximately 47,000 and 45,000 shares, respectively, because the effect would be anti-dilutive in periods when there is a net loss. The computation of diluted net income per common share for the three and six months ended June 30, 2007 also excludes the effect of the potential exercise of options to purchase approximately 1.8 million and 1.7 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.

12. Legal Proceedings

From time to time, the Company could be subject to claims arising in the ordinary course of business or be a defendant in lawsuits. While the outcome of such claims or other proceedings cannot be predicted with certainty, the Company s management 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.

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 Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. 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, forward-looking statements can be identified 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, 2007.

Overview

SCM Microsystems, Inc. (SCM, the Company, we and us) was incorporated in 1996 under the laws of the state 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 in two market segments: PC Security and Digital Media Readers.

For the PC Security market, we offer smart card reader technology that enables authentication of individuals for applications such as electronic passports and drivers licenses, electronic healthcare cards, secure logical access to PCs and networks, and physical access to facilities. Within the PC Security segment, we also offer a line of smart card solutions under the CHIPDRIVE® brand that include productivity applications such as time recording and attendance, physical access and password management for small and medium sized enterprises.

For the Digital Media Reader 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 and photo processing 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 solutions) business to Kudelski S.A. As a result, we have accounted for the DTV solutions business as a discontinued operation, and the statements of operations and cash flows for all periods presented reflect the discontinuance of this business. In addition, our operations previously included a retail Digital Media and Video business, which we sold in the third quarter of 2003.

As a result of this sale and divestiture, beginning in the second quarter of fiscal 2003, we have accounted for the retail Digital Media and

Video business as a discontinued operation, and statements of operations for all periods presented reflect the discontinuance of this business. (See Note 3 to Condensed Consolidated Financial Statements of this Form 10-Q.)

Historically, we have sold a significant proportion of our PC Security products to the U.S. government for PC and network access by military and federal employees, and these sales have been an important component of our overall revenue. In the first half of 2008, we have experienced weak demand for our smart card readers from the U.S. government sector, primarily due to a reduced level of overall activity in the market as a result of ongoing project and budget delays. During this same period, we have experienced increased sales in Asia of lower-priced interface chips for embedded smart card readers, as demand in the U.S. government sector and elsewhere has shifted away from external reader devices towards readers embedded within laptops and keyboards. We continue to believe that we remain a leading supplier of smart card reader technology to the U.S. government market and that we are not losing share to competitors. However, lower overall market opportunity and the shift in demand to embedded readers in the U.S. government market have resulted in reduced revenue for us, which we believe is not likely to return to previous levels. We have put in place a number of strategies to offset the decline in our US government business and to grow revenues over the long-term, as discussed below.

Throughout most of 2007, our revenue growth strategy was primarily based on the introduction of new PC Security products to address emerging smart card-based security programs in Europe, including e-passport, national ID and e-health. Additionally, we implemented programs to expand sales of our CHIPDRIVE business productivity solutions to markets outside Germany. We also continued our traditional focus on the U.S. government market, providing smart card readers for authentication programs within various federal agencies; as well as providing digital media readers for the photo kiosk market in the U.S. In the first half of 2008, we sold our first CHIPDRIVE products in non-German markets.

In late 2007, we began to implement a new growth strategy that aims to expand sales of existing product lines into new geographic markets and to diversify and expand our customer base. As part of this strategy, we added sales resources in Europe, Latin America, Asia and the U.S. to increase our ability to address current and future business opportunities. For example, we added sales resources to target authentication programs in the government and enterprise sectors in Latin America and Asia and we began targeting the photo kiosk markets in Europe and Asia. As sales cycles for government projects and design cycles for photo kiosks may take several months, we believe we will begin to realize revenue from these investments in late 2008.

In early 2008, we implemented an additional growth strategy aimed at further diversifying and expanding our customer base by targeting the emerging contactless reader market. We have begun to develop new PC Security products based on contactless technologies such as Near Field Communication and FeliCa® and have initiated business development activities aimed at penetrating the worldwide financial services and enterprise markets with our contactless reader products. We believe this strategy is beginning to have a positive impact on our business, as sales of our new contactless readers comprised a significant percentage of revenue in our PC Security business in the second quarter of 2008.

Additionally, in late 2007 and in early 2008, we reorganized and strengthened our management team with key executive hires and promotions. Felix Marx joined as Chief Executive Officer in October 2007; Sour Chhor joined as Executive Vice President, Strategy, Marketing and Engineering in February 2008; and Manfred Mueller was promoted to Executive Vice President, Strategic Sales and Business Development in March 2008. In the first half of 2008 we have also added expertise in contactless technologies and the contactless market with the addition of new sales, marketing and engineering staff from the contactless industry. We believe our new executives and the new structure of our executive team strengthen our ability to anticipate and respond to market trends both in the traditional smart card industry and in the emerging market for contactless solutions.

In our continuing operations, we may experience significant variations in demand for our products quarter to quarter. This is particularly true for our PC Security products, a significant proportion of which are currently sold for 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 testing and compliance schedules of government bodies as well as roll-out schedules for application deployments, both of which contribute to variability in demand from quarter to quarter. Sales of our Digital Media Reader products are less subject to this variability based on market or project

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

Both our PC Security and Digital Media Reader businesses are subject to ongoing pricing pressure. To counter this trend, we have implemented cost reduction programs that have resulted in ongoing improvements to our product margins.

We believe we can also continue to offset pricing pressure and material cost increases with ongoing improvements in our supply chain systems.

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 (U.S. GAAP). 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 might be required, which could have a material impact on our results of operations.

We typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. We regularly review inventory quantities on hand and record an estimated provision for excess inventory, technical obsolescence and no sale-ability based primarily on our historical sales and expectations for future use. Actual demand and market conditions may be different from those projected by our management. This could have a material effect on our operating results and financial position. If we were to make different judgments or utilize different estimates, the amount and timing of our write-down of inventories could be materially different. Excess inventory frequently remains saleable. When excess inventory is sold, it yields a gross profit margin of up to 100%. Sales of excess inventory have the effect of increasing the gross profit margin beyond that which would otherwise occur, because of previous write-downs. Once we have written down inventory below cost, we do not subsequently write it up.

We adopted the Financial Accounting Standards Board s (FASB) Interpretation No. 48, *Accounting For Uncertain Tax Positions* (FIN 48) in the first quarter of 2007. We are required to make certain judgments and estimates in determining income tax expense for financial statement purposes. Significant changes to these estimates may result in an increase or decrease to our tax provision in a subsequent period. The calculation of our tax liabilities requires dealing with uncertainties in the application of complex tax regulations. FIN 48 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. It is inherently difficult and subjective to estimate such amounts. We reevaluate such uncertain tax positions on a quarterly basis based on factors such as, but not limited to, changes in tax laws, issues settled under audit and changes in facts or circumstances. Such changes in recognition or measurement might result in the recognition of a tax benefit or an additional charge to the tax provision in the period.

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 June 30, 2008, we have recorded valuation allowances against 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. Actual operating results and the underlying amount and category of income in future years could

render our current assumptions, judgments and estimates of the realizability of deferred tax assets inaccurate, which could have a material impact on our financial position or results of operations.

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, which could have a material impact on our results of operations.

During previous years, we have recorded restructuring charges as we rationalized operations in light of strategic decisions to align our business focus on certain markets. These measures, which included major changes in senior management, workforce reduction, facilities consolidation and the transfer of our production to contract manufacturers, were largely intended to align our capacity and infrastructure to anticipate customer demand and to transition our operations to better cost efficiencies. 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. Statement of Financial Accounting Standard (SFAS) 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. Given the significance of, and the timing of the execution of such activities, this process is complex and involves periodic reassessments of original estimates. 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 and other plans, actual results may differ, thereby requiring us to record additional provisions or reverse a portion of such provisions.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)). Under SFAS No. 141(R), an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred, restructuring costs generally be expensed in periods subsequent to the acquisition date, and changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period impact income tax expense. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. The adoption of SFAS No. 141(R) will change our accounting treatment for business combinations on a prospective basis beginning in the first quarter of fiscal year 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. SFAS No. 160 changes the accounting and reporting for minority interests, which will be recharacterized as non-controlling interests and classified as a component of equity. SFAS No. 160 is effective for us on a prospective basis for business combinations with an acquisition date beginning in the first quarter of fiscal year 2009. As of June 30, 2008, we did not have any minority interests.

On January 1, 2008, we adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits companies to choose to measure certain financial instruments and other items at fair value using an instrument-by-instrument election. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. The adoption of SFAS No. 159 did not have an impact on our consolidated financial position, results of operations or cash flows.

On January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements*, for all financial assets and financial liabilities and for all non-financial assets and non-financial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis (i.e., at least annually). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. SFAS No. 157 does not change

the accounting for those instruments that were, under previous GAAP, accounted for at cost or contract value. The adoption of SFAS No. 157 did not have a significant impact on our consolidated financial statements, and the resulting fair values calculated under SFAS No. 157 after adoption were not significantly different than the fair values that would have been calculated under previous guidance.

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable objective inputs and minimize the use of unobservable inputs, which require additional reliance on the Company s judgment, when measuring fair value. A financial instrument s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. SFAS No. 157 establishes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices for identical instruments in active markets;

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-derived valuations, in which all significant inputs are observable in active markets; and

Level 3 Valuations derived from valuation techniques, in which one or more significant inputs are unobservable.

We use the following classifications to measure different financial instruments at fair value, including an indication of the level in the fair value hierarchy in which each instrument is generally classified:

Cash equivalents include highly liquid debt investments (money market fund deposits and commercial papers) with maturities of three months or less at the date of acquisition. These financial instruments are classified in Level 1 of the fair value hierarchy.

Short term investments consist of corporate notes and United States government agency instruments and are classified as available-for-sale. These financial instruments are classified in Level 1 of the fair value hierarchy. As of June 30, 2008, the company has no short term investments.

Assets that are measured and recognized at fair value on a recurring basis classified under the appropriate level of the fair value hierarchy as of June 30, 2008 were as follows (in thousands):

	Level 1	**Level 2**	**Level 3**	**Total**
Money market fund deposits	$ 16,168	$	$	$ 16,168
Commercial papers	5,967			5,967
Total:	$ 22,135	$	$	$ 22,135

As of June 30, 2008, there are no liabilities that are measured and recognized at fair value on a recurring basis.

In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements that Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13* (FSP 157-1) and FSP 157-2, *Effective Date of FASB Statement No. 157*. FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. We are currently evaluating the impact that SFAS No. 157 will have on our consolidated financial statements when it is applied to non-financial assets and non-financial liabilities that are not measured at fair value on a recurring basis beginning in the first quarter of 2009.

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Results of Operations

Net Revenue. Summary information by product segment for the three and six months ended June 30, 2008 and 2007 is as follows (in thousands):

	Three months ended June 30,		% change period to period	Six months ended June 30,		% change period to period
	2008	**2007**		**2008**	**2007**	
PC Security						
Revenue	$4,878	$3,864	26%	$ 9,885	$10,960	(10)%
Gross profit	2,276	1,256		4,423	4,499	
Gross profit %	47%	33%		45%	41%	
Digital Media Readers						
Revenue	$1,642	$ 783	110%	$ 3,099	$ 2,144	45%
Gross profit	547	77		1,083	574	
Gross profit %	33%	10%		35%	27%	
Total:						
Revenue	$6,520	$4,647	40%	$12,984	$13,104	(1)%
Gross profit	2,823	1,333		5,506	5,073	
Gross profit %	43%	29%		42%	39%	

Net revenue for the second quarter of 2008 was $6.5 million, up 40% from $4.6 million for the same period of 2007. The increase in second quarter revenue year over year was driven by higher sales of both our PC Security and Digital Media Reader products. For the first six months of 2008, net revenue was $13.0 million, down 1% from revenue of $13.1 million for the first six months of 2007. The decrease in revenue for the six months of 2008 compared with the prior year period resulted from lower sales of our PC Security products in the first quarter of 2008 that were only partially offset by higher sales of our Digital Media Reader products.

Our PC Security product line principally consists of smart card readers and related chip technology that are primarily used in large security programs where smart cards are employed to authenticate the identity of people in order to control access to computers or computer networks; borders; buildings and other facilities; and services, such as health care. Also included in this business segment are our CHIPDRIVE software and reader solutions, which provide electronic timecard and other productivity applications for small and medium enterprises and are primarily sold in Europe. The majority of revenue in our PC Security business segment is government, financial or enterprise programs and is subject to significant variability based on the size and timing of customer orders.

Sales of our PC Security products were $4.9 million in the second quarter of 2008, up 26% from sales of $3.9 million in the second quarter of 2007. Sales levels in the second quarter of 2007 reflected budget freezes in the U.S. federal government sector and delays in European smart card projects during the period.

In the second quarter of 2008, sales to the U.S. government sector were impacted by overall weak demand. In addition, demand for external smart card readers for U.S. government programs continued to decline in favor of readers embedded within keyboards and laptops. We sold large volumes of smart card interface chips for embedded readers to laptop and keyboard manufacturers in Asia in the second quarter of 2008; however these chips have a lower average selling price than our external smart card readers. European sales of our PC Security products in the second quarter of 2008 were strong and balanced across various markets, including enterprise, government and small business, and across geographic regions. We also experienced significant sales contribution from our new contactless reader products.

For the first six months of 2008, sales of PC Security products were $9.9 million, down 10% from sales of $11.0 million for the first six months of 2007. The decrease in sales in the first six months of 2008 compared with the

prior year was primarily due to a significant reduction in sales of our smart card reader products for U.S. government authentication programs, as a result of weak demand overall in this market and increasing demand for readers embedded within laptops and keyboards rather than external reader devices. This decrease was somewhat offset by the higher sales in Asia of interface chips for embedded readers.

Our Digital Media Reader product line consists of digital media readers and related ASIC technology used to provide an interface for flash memory cards, primarily embedded in digital photography kiosks, where the readers are used to download and print digital photos. Two to three customers, historically, have accounted for approximately two-thirds of sales in this business segment. As a result, revenue in our Digital Media Reader product line can fluctuate significantly quarter to quarter due to variability in the size and timing of customer orders.

Sales of our Digital Media Reader products were $1.6 million in the second quarter of 2008, an increase of 110% from sales of $0.8 million in the same period of 2007. For the first six months of 2008, sales of Digital Media Reader products were $3.1 million, up 45% from sales of $2.1 million for the first six months of 2007. The increase in Digital Media Reader sales in both the second quarter and the first six months of 2008 compared with the same periods of the prior year was primarily due to a significant reduction in orders from one of our two major customers in the second quarter of 2007 as a result of significantly reduced demand in its end markets.

Gross Profit. Gross profit for the second quarter of 2008 was $2.8 million, or 43% of revenue, compared with $1.3 million, or 29% of revenue in the second quarter of 2007.

Gross profit for our PC Security products was 47% of revenue for the second quarter of 2008, compared with 33% for the second quarter of 2007. The increase in gross profit in the second quarter of 2008 compared with the same period of 2007 was primarily due to higher revenue levels in the 2008 period, as well as a more favorable mix of higher margin products, including a relatively higher proportion of sales of our CHIPDRIVE products, and product cost reductions.

Gross profit for our Digital Media Reader products was 33% for the second quarter of 2008, up from 10% for the second quarter of 2007. The increase in gross profit in the second quarter of 2008 compared with the same period of 2007 was primarily due to higher revenue levels in the 2008 period.

For the first six months of 2008, gross profit was $5.5 million, or 42% of revenue, compared with $5.1 million, or 39% of revenue for the first six months of 2007. The improvement in gross profit margin in the first six months of 2008 compared with the prior year primarily is due to a more favorable mix of higher margin products overall and product cost reductions in our PC Security business.

We expect there will be some variation in our gross profit from period to period, as 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, inventory write-downs and the cost and availability of components.

Research and Development.

(In thousands)	**Three months ended June 30**		**% change period to period**	**Six months ended June 30**		**% change period to period**
	2008	**2007**		**2008**	**2007**	
Expenses	$1,043	$792	32%	$2,078	$1,512	37%
Percentage of total revenues	16%	17%		16%	12%	

Research and development expenses consist primarily of employee compensation and fees for the development of hardware and firmware products.

We focus the bulk of our research and development activities on the development of products for new and emerging market opportunities. Research and development expenses were $1.0 million in the second quarter of 2008, or 16% of revenue, compared with $0.8 million in the second quarter of 2007, or 17% of revenue, an increase of 32%. For the first six months of 2008, research and development expenses were $2.1 million, or 16% of revenue, compared with $1.5 million, or 12% of revenue for the first six months of 2007, an increase of 37%. Higher research and development expenses in the second quarter and first six months of 2008 compared with the prior year are primarily due to the development of new contactless PC Security products and increased development activity related to readers for the German e-health program.

We expect our research and development expenses to vary based on future project demands and on the markets we target.

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Selling and Marketing.

(In thousands)	Three months ended June 30		% change period to period	Six months ended June 30		% change period to period
	2008	**2007**		**2008**	**2007**	
Expenses	$2,569	$1,618	59%	$4,730	$3,177	49%
Percentage of total revenues	39%	35%		36%	24%	

Selling and marketing expenses consist primarily of employee compensation as well as tradeshow participation and other marketing costs. We focus a significant proportion of our sales and marketing activities on new and emerging market opportunities, including government authentication, e-health, financial services and the market for time recording solutions for small- and medium-sized businesses. Selling and marketing expenses were $2.6 million in the second quarter of 2008, or 39% of revenue, compared with $1.6 million in the second quarter of 2007, or 35% of revenue, an increase of 59%. For the first six months of 2008, sales and marketing expenses were $4.7 million, or 36% of revenue, compared with $3.2 million, or 24% of revenue in the first six months of 2007, an increase of 49%. Higher sales and marketing expenses in the second quarter and first six months of 2008 compared with the prior year are primarily due to the hiring of new sales resources over the past several quarters in Latin America, Asia, Europe and the U.S. to enhance our ability to address current and future business opportunities, as well as an increased level of travel expenses related to new business development activities. Also included in the second quarter and first six months of 2008 are approximately $0.2 million in severance costs associated with the reorganization of our product marketing function as part of our strategy to enter the contactless market.

General and Administrative.

(In thousands)	Three months ended June 30		% change period to period	Six months ended June 30		% change period to period
	2008	**2007**		**2008**	**2007**	
Expenses	$1,518	$2,879	(47)%	$3,021	$4,279	(29)%
Percentage of total revenues	23%	62%		23%	33%	

General and administrative expenses consist primarily of compensation expenses for employees performing administrative functions, and professional fees arising from legal, auditing and other consulting services.

In the second quarter of 2008, general and administrative expenses were $1.5 million, or 23% of revenue, compared with $2.9 million, or 62% of revenue in the second quarter of 2007, a decrease of 47%. Included in the second quarter of 2007 are severance and other costs associated with the resignation of our former chief executive officer, totaling $1.4 million. For the first six months of 2008, general and administrative expenses were $3.0 million, compared with $4.3 million in the first six months of 2007, a decrease of 29%, which included the $1.4 million in severance and other costs as mentioned above. General and administrative expenses in the first six months of 2008 have been negatively impacted by the devaluation of the dollar against foreign currencies, mainly the euro, as we pay the majority of these expenses in local currency but account for those expenses in dollars.

Amortization of Intangibles. Amortization of intangibles was zero during the second quarter of 2008, compared with $0.1 million during the second quarter of 2007. For the first six months of 2008, amortization of intangibles was zero, compared with $0.3 million during the first six months of 2007. No further amounts remain to be amortized in future periods as the intangible assets have been fully amortized.

Interest and Other Income, Net. Interest and other income, net consists of interest earned on invested cash and foreign currency gains or losses.

In the second quarter of 2008, interest income resulting from invested cash balances was $0.2 million, compared with interest income of $0.4 million for the second quarter of 2007. In the first six months of 2008, interest income was $0.5 million, compared with interest income of $0.7 million in the first six months of 2007. The reduction in interest income reflects the reduced cash balance and the reduction in interest rates in 2008 compared to 2007.

Foreign currency gains were $0.2 million in the second quarter of 2008 and zero in the second quarter of 2007. Foreign currency gains were $0.4 million in the first six months of 2008 compared to a foreign currency loss of $0.1 million for the first six months of 2007.

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Income Taxes. In the second quarter and for the first six months of 2008, we recorded a provision for income taxes of $1,000 and $48,000, respectively, primarily for minimum taxation, which could not be offset with operating loss carryforwards and tax expenses in a foreign subsidiary with no loss carryforwards.

In the second quarter and first six months of 2007, we recorded a provision for income taxes of $32,000 and $0.1 million, respectively, primarily for minimum taxation, which could not be offset with operating loss carryforwards and tax expenses in a foreign subsidiary with no loss carryforwards.

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 both the three and six months ended June 30, 2008 was zero. Net revenue for the DTV solutions business in the three and six months ended June 30, 2007 was zero and $0.5 million, respectively. Operating loss for the DTV solutions business in the three and six months ended June 30, 2008 was $2,000 and $6,000, respectively. Operating loss for the DTV solutions business for the three and six months ended June 30, 2007 was $46,000 and $12,000, respectively.

In May 2007, we received a final payment of $1.6 million from Kudelski related to the sale of our DTV solutions business that resulted in a $1.5 million gain on sale of discontinued operations in the first quarter of 2007 (See Note 3 to Condensed Consolidated Financial Statements). During the three and six months ended June 30, 2007, net gain on the disposal of discontinued operations was approximately $1.5 million and $1.6 million, 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 zero in each of the three and six months ended June 30, 2008 and 2007. Operating loss for the retail Digital Media and Video business was $0.1 million in both the three and six months ended June 30, 2008, and operating loss for the retail Digital Media and Video business was $0.1 million and $0.2 million for the three and six months ended June 30, 2007, respectively.

In April 2008, we entered into an agreement to terminate our lease agreement for the premises leased in the UK, which resulted in approximately $0.4 million gain on sale of discontinued operations. During the three and six months ended June 30, 2008, the total net gain on the disposal of discontinued operations was approximately $0.5 million.

Liquidity and Capital Resources

As of June 30, 2008, our working capital, which we have defined as current assets less current liabilities, was $30.7 million, compared to $34.0 million as of December 31, 2007, a decrease of approximately $3.3 million. The reduction in working capital for the first six months of 2008 primarily reflects lower cash and cash equivalents and short-term investments of $4.5 million, partly offset by a $1.2 million decrease of current liabilities. Accounts receivable, inventories and other current assets combined have remained relatively unchanged.

Cash and cash equivalents and short-term investments were $28.0 million as of June 30, 2008, a decrease of approximately $4.5 million compared to the balance of $32.4 million as of December 31, 2007.

The following summarizes our cash flows for the six months ended June 30, 2008 (in thousands):

		Six Months Ended June 30, 2008
Operating cash used in continuing operations	$	(3,592)
Operating cash used in discontinued operations		(664)
Investing cash provided		13,714
Financing cash flow		18
Effect of exchange rate changes on cash and cash equivalents		(85)
Increase in cash and cash equivalents		9,391
Cash and cash equivalents at beginning of period		18,600

Cash and cash equivalents at end of period	$	27,991

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During the first six months of 2008, cash used in operating activities was $4.3 million. This use of cash consisted of a net loss of $3.2 million, the use of approximately $0.3 million from net changes in operating assets and liabilities and the use of approximately $1.0 million from the net changes in the assets and liabilities from discontinued operations, partially offset by cash flow adjustments for depreciation, amortization and stock compensation totaling $0.3 million.

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 $4.9 million at June 30, 2008. As of June 30, 2008, inventory and other purchase commitments due within one year were approximately $11.9 million and additional inventory and other purchase commitments due within two years were approximately $3.0 million.

We currently expect that our current capital resources and available borrowings should be sufficient to meet our operating and capital requirements through at least the end of 2008. 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 from investing activities for the six months ended June 30, 2008 was primarily from the maturity of short-term investments of $13.9 million.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no significant change in our exposure to market risk during the three months ended June 30, 2008. For discussion of SCM s exposure to market risk, refer to Item 7A, Quantitative and Qualitative Disclosures About Market Risk, contained in the Company s Annual Report incorporated by reference in Form 10-K for the year ended December 31, 2007.

Item 4. Controls and Procedures

Attached as exhibits to this Form 10-Q are certifications of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (the Exchange Act). This Controls and Procedures section includes information concerning the controls and controls evaluation referred to in the certifications.

(a) Evaluation of Disclosure Controls and Procedures

As of June 30, 2008, SCM carried out an evaluation, as required in Rule 13a-15(b) under the Exchange Act, under the supervision and with the participation of our management, including our CEO and CFO, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act. Based on this evaluation, our CEO and CFO concluded that, as of June 30, 2008, our disclosure controls and procedures were effective to provide reasonable assurance that that the information required to be disclosed in our Securities and Exchange Commission (SEC) reports that we file or furnish under the Exchange Act (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 CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. In the course of this evaluation, we sought to identify any significant deficiencies or material weaknesses in our disclosure controls and procedures, to determine whether we had identified any acts of fraud involving personnel who have a significant role in our disclosure controls and procedures, and to confirm that any necessary corrective action, including process improvements, was taken. The overall goals of these evaluation activities are to monitor our disclosure controls and procedures and to make modifications as necessary. We intend to maintain these disclosure controls and procedures, modifying them as circumstances warrant.

(b) Changes in Internal Controls over Financial Reporting

In connection with our continued monitoring and maintenance of our controls procedures as part of the implementation of section 404 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 second quarter of 2008 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

(c) Inherent Limitations on Effectiveness of Controls

A control system, no matter how well designed and operated, can only provide reasonable assurances that the objectives of the control system are met. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within SCM have been or will be detected.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, SCM could be subject to claims arising in the ordinary course of business or be a defendant in lawsuits. While the outcome of such claims or other proceedings cannot be predicted with certainty, SCM s management 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.

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 in the following risk factors 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 risks, 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 $195.3 million as of June 30, 2008. In the future, we may not be able to achieve expected results, including any guidance or outlook we may provide from time to time; we may continue to incur losses; and we may be unable to achieve or maintain profitability.

Our quarterly and annual operating results will likely fluctuate.

Our quarterly and annual 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, seasonal demand, product plans or program roll-out schedules;
- cancellations or delays of customer product orders, or the loss of a significant customer;
- our ability to obtain an adequate supply of components on a timely basis;
- poor quality in the supply of our components;
- delays in the manufacture of our products;
- the absence of significant backlog in our business;
- our 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 market segments;
- the sales volume, product configuration and mix of products that we sell;
- technological changes in the markets for our products;
- the rate of adoption of industry-wide standards;
- 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 or decreases in demand for our products resulting from fluctuations in our customers budgets, purchasing patterns or deployment schedules. These occurrences are not always predictable and can have a significant impact on our results in the period in which they occur.

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:

low volumes of trading activity in our stock, particular in the U.S.;

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 photo processing 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 revenues. Sales to our top ten customers accounted for approximately 57% of revenue in the first six months of 2008 and 61% of revenue in fiscal year 2007. 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 Digital Media Reader business, where approximately two-thirds of our business has typically been generated by two or three customers. 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, could significantly lower our revenues in any period and would increase our dependence on a smaller group of our remaining customers. 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 emerging applications in our target markets and on diversifying and expanding our customer base in new markets and geographic regions, and with new products.

We sell our products primarily to address emerging applications that have not yet reached a stage of mass adoption or deployment. For example, we sell our smart card readers for use in various smart card-based security programs in

Europe, such as electronic driver s licenses, national IDs and e-passports, which are applications that are not yet widely implemented. In recent months we have also focused on expanding sales of existing product lines into new geographic markets and diversifying and expanding our customer base. For example, recently we have added sales resources to target authentication programs in the government and enterprise sectors in Latin America and Asia, and have begun to target the photo kiosk markets in Europe and Asia. We have also initiated business development activities aimed at penetrating the worldwide financial services and enterprise markets with new contactless reader products. Because the markets for our products are still emerging, demand for our products is subject to variability from period to period. There is no assurance that demand will become more predictable as additional smart card programs demonstrate success. If demand for products to enable smart card-based security applications 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 the size or composition of the market for any of our products. Our target markets have not consistently 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. 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 for emerging applications in our target 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 large scale security programs involving smart cards and related technology by governments, banks and enterprises;
- the ability of financial institutions, corporate enterprises, the U.S. government and other governments to agree on industry specifications and to develop and deploy security applications that will drive demand for reader solutions 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.

A significant portion of our revenue is dependent upon sales for government programs, which are impacted by uncertainty of timelines and budgetary allocations, as well as by delays in developing standards for information technology (IT) projects and in coordinating all aspects of large smart card-based security programs.

Large government programs are a primary target for our PC Security business, as smart card technology is increasingly used to enable applications ranging from paying taxes online, to citizen identification, to receiving health care. Historically, we have sold a significant proportion of our PC Security products to the U.S. government for PC and network access by military and federal employees, and these sales have been an important component of our overall revenue. In recent periods, we have experienced a significant decrease in sales of our smart card readers to the U.S. government, primarily due to weaker demand in this market as a result of ongoing project and budget delays. At the same time, we have sold increasing volumes of smart card interface chips to laptop and keyboard manufacturers in Asia, as computer users in the U.S. government sector and elsewhere have begun to prefer purchasing computer equipment with embedded reader capabilities rather than external card readers. We continue to believe that we remain a leading supplier of smart card reader technology to the U.S. government market and that we are not losing share to competitors. However, lower overall market demand and the replacement of smart card reader sales with sales of lower-priced interface chips for embedded readers have resulted in reduced revenue from the U.S. government sector, which we believe is not likely to return to previous levels. We anticipate that a significant portion of our future revenues will come from government programs outside the U.S., such as national identity, e-government, e-health and others applications. We currently supply smart card readers for various government programs in Europe and Asia and are actively targeting additional programs in these areas as well as in Latin America. We have also spent significant resources developing a range of e-health smart card terminals for the German government s electronic healthcard program. However, the timing of government smart card programs is not always certain and delays in program implementation are common. For example, while the German government has stated that it plans to distribute new electronic health cards to its citizens beginning in late 2008 and to have in place a corresponding network and card reader infrastructure by 2009, there have already been delays in this program and the actual timing of equipment and card deployments in the German e-health program remain uncertain. The continued delay of government projects for

any reason could negatively impact our sales.

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 or manufacture, 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.

We provide 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 us to make estimates of product return rates and expected costs to repair or to replace the products under warranty. We currently establish 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 our estimates, adjustments to recognize additional cost of sales may be required in future periods.

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 or 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.

The use of contract manufacturing 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. 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 for some key components of our products. For example, we currently utilize the foundry services of two suppliers to produce our ASICs for smart cards readers, and we use chips and antenna components from one supplier in our contactless smart card readers. Our reliance on a limited number of suppliers may expose us to various risks including, without limitation, an inadequate supply of components, price increases, late deliveries and poor component quality. In addition, some of the basic components we use in our products, such as digital flash media, may at any time be in great demand. 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. For example, external smart card reader devices that plug into a PC to provide security in the logon process are being replaced by integrated smart card interface chips that are embedded directly into laptops or keyboards. 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. We may also lose market share.

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. For example, we are currently developing a range of new products featuring a secure wireless connectivity known as Near Field Communication, which we believe will be important to capture business in the future. 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

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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 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.

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

If demand is less than anticipated, customers may ask that we accept returned products that they do not believe they can sell. We do not have a policy relating to product returns; however, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. If we were to accept product returns, 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.

Changes in tax laws or the interpretation thereof, adverse tax audits and other tax matters may adversely affect our future results.

A number of factors impact our tax position, including:

- the jurisdictions in which profits are determined to be earned and taxed;
- the resolution of issues arising from tax audits with various tax authorities;
- changes in the valuation of our deferred tax assets and liabilities;
- adjustments to estimated taxes upon finalization of various tax returns;
- increases in expenses not deductible for tax purposes; and
- the repatriation of non-U.S. earnings for which we have not previously provided for U.S. taxes.

Each of these factors make it more difficult for us to project or achieve expected tax results. An increase or decrease in our tax liabilities due to these or other factors could adversely affect our financial results in future periods.

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 May 2, 2008, the record date for our 2008 Annual Meeting of Stockholders, approximately 50% of our shares outstanding were held by retail stockholders in Germany, through German banks and brokers. Securities regulations and business 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.

As a result, it is often difficult and costly for us, and requires considerable management resources, to achieve a quorum at annual and special meetings of our stockholders, and we may not 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 may not be successful in obtaining such approval. The 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. 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.

One of our directors is a beneficial owner of a significant shareholding in our Company, and therefore may have significant influence over the outcome of corporate actions requiring shareholder approval; however his priorities for our business may be different from the Company s or our other shareholders.

As of June 30, 2008, Lincoln Vale European Partners holds nearly 10% of the outstanding shares of our common stock. Dr. Hans Liebler, one of our directors, is a partner of Lincoln Vale and may be deemed to beneficially own, either directly or indirectly through limited partnerships of which he has management control, the shares invested by Lincoln Vale in our Company. Accordingly, Dr. Liebler could have significant influence over the outcome of corporate actions requiring shareholder approval, including the election of directors, any merger, consolidation or sale of all or substantially all of our assets or any other significant corporate transaction. Dr. Liebler could delay or prevent a change of control of our company, even if such a change of control would benefit our other shareholders.

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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, including Germany, India, Japan and the United States. We also must manage contract manufacturers in several different countries, including, for example, Singapore. Managing our various development, sales, administrative and manufacturing 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.

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 65% of our revenue for the six months ended June 30, 2008 and approximately 49% of our revenue for the year ended December 31, 2007 was 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;
- potentially adverse tax consequences;
- longer accounts receivable collection cycles;
- difficulty in managing widespread sales and manufacturing operations; and

less effective protection of intellectual property.

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Fluctuations in the valuation of foreign currencies could impact costs and/or revenues we disclose in U.S. dollars, and could result in foreign currency 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 exchange gains and losses. If a significant portion of operating expenses are incurred in a foreign currency such as the euro, and revenues are generated in U.S. dollars, exchange rate fluctuations might have a positive or negative net financial impact on these transactions, depending on whether the U.S. dollar devalues or revalues compared to the euro. For example, excluding a one-time severance payment made to our former chief executive officer in the second quarter of 2007, our general and administrative expenses in the first half of 2008 were higher than in the same period of the previous year, primarily due to the devaluation of the dollar as compared with the euro. We cannot predict the effect of exchange rate fluctuations upon future quarterly and annual operating results. The effect of currency exchange rate changes may increase or decrease our costs and/or revenues in any given quarter, and 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 and directors 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 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; integrating internal controls over financial reporting; discovering and correcting deficiencies in internal controls and other regulatory compliance, data adequacy and integrity, product quality and product liabilities; 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 may not be successful with any such acquisition.

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. 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 such divestiture or disposition. In addition, we may not achieve the expected price in a divestiture transaction. 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. We may not be successful in protecting 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 we may not 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 or 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 U.S. GAAP. 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. Any changes in accounting rules or policies in the future may result in significant accounting charges.

We face costs and risks associated with maintaining effective internal controls over financial reporting, and if we fail to achieve and maintain adequate internal controls over financial reporting, our business, results of operations and financial condition, and investors confidence in us could be materially affected.

Under Sections 302 and 404 of the Sarbanes-Oxley Act of 2002, our management is required to make certain assessments and certifications regarding our disclosure controls and internal controls over financial reporting. We have dedicated, and expect to continue to dedicate, significant management, financial and other resources in connection with our compliance with Section 404 of the Sarbanes-Oxley Act during and after 2007. The process of maintaining and evaluating the effectiveness of these controls is expensive, time-consuming and requires significant attention from our management and staff. During the course of our evaluation, we may identify areas requiring improvement and may be required to design enhanced processes and controls to address issues identified through this review. This could result in significant delays and costs to us and require us to divert substantial resources, including management time from other activities. We have found a 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 not be able to rely on the integrity of our financial results, which could result in inaccurate or late reporting of our financial results and investigation by regulatory authorities. If we fail to achieve and maintain adequate internal controls 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 and operated, can only provide reasonable assurance that the objectives of the control system are met. Because there are inherent limitations in all control systems, no evaluation of control can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been or will be detected. 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. Any failure of our internal control systems to be effective could adversely affect our business.

We face risks from litigation.

From time to time, we may be subject to litigation, which could include, among other things, 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 such 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 returns of products 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.

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. We may not be able 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 the acquisition of SCM 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.

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

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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.

These provisions will apply even if the offer were to be considered adequate by some of our stockholders. Because these provisions may be deemed to discourage a change of control, they may delay or prevent the acquisition of our Company, which could decrease the value of our common stock.

You may experience dilution of your ownership interests due to the future issuance of additional shares of our stock, and future sales of shares of our common stock could have an adverse effect on our stock price.

From time to time, in the future we may issue previously authorized and unissued securities, resulting in the dilution of the ownership interests of our current stockholders. We are currently authorized to issue up to 40,000,000 shares of common stock. As of August 5, 2008, 15,743,515 shares of common stock were outstanding.

In 2007, our Board of Directors and our stockholders approved our 2007 Stock Option Plan, under which options to purchase 1.5 million shares of our common stock may be granted. As of June 30, 2008, an aggregate of approximately 3.1 million shares of common stock was reserved for future issuance under our stock option plans, of which 2.0 million shares were subject to outstanding options. We may issue additional shares of our common stock or other securities that are convertible into or exercisable for shares of our common stock in connection with the hiring of personnel, future acquisitions, future private placements, or future public offerings of our securities for capital raising or for other business purposes. If we issue additional securities, the aggregate percentage ownership of our existing stockholders will be reduced. In addition, any new securities that we issue may have rights senior to those of our common stock.

In addition, the potential issuance of additional shares of our common stock or preferred stock, or the perception that such issuances could occur, may create downward pressure on the trading price 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.

At our Annual Meeting on July 1, 2008, the following matters were acted upon by the stockholders of the Company:

1. The election of Steven Humphreys, Hans Liebler and Stephan Rohaly as Class I directors of the Company, to hold office for a three-year term or until their successors are elected and qualified; and

2. Ratification of the appointment of Deloitte & Touche as independent registered public accountants of the Company for the fiscal year ending December 31, 2008.

The number of shares of our common stock outstanding and entitled to vote at our 2008 Annual Meeting was 15,743,515 and 6,509,359 shares were represented in person or by proxy at the Annual Meeting on July 1, 2008, 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 Withheld
1. Election of Directors		
Steven Humphreys	4,954,264	1,555,095
Hans Liebler	6,474,682	34,677
Stephan Rohaly	6,492,394	16,965

	Votes For	Votes Against	Votes Abstained
2. Ratification of Independent Auditors	6,491,397	3,317	14,645

Item 5. Other Information.

None

Item 6. Exhibits

Exhibits are listed on the Index to Exhibits at the end of this Quarterly Report. The exhibits required by Item 601 of Regulation S-K, listed on such Index in response to this Item, are incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements 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.
August 12, 2008	/s/ Felix Marx Felix Marx Chief Executive Officer
August 12, 2008	/s/ Stephan Rohaly Stephan Rohaly Chief Financial Officer and Secretary

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EXHIBIT INDEX

Exhibit Number	DESCRIPTION OF DOCUMENT
3.1(1)	Fourth Amended and Restated Certificate of Incorporation.
3.2(2)	Amended and Restated Bylaws of Registrant.
3.3(3)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of SCM Microsystems, Inc.
4.1(1)	Form of Registrant s Common Stock Certificate.
4.2(3)	Preferred Stock Rights Agreement, dated as of November 8, 2002, between SCM Microsystems, Inc. and American Stock Transfer and Trust Company.
10.1(4)*	Supplementary Employment Agreement between SCM Microsystems GmbH and Felix Marx dated July 30, 2008.
10.2(4)*	Supplementary Employment Agreement between SCM Microsystems GmbH and Stephan Rohaly dated July 30, 2008.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32	Certification 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.

(1) Filed previously as an exhibit to SCM s Registration Statement on Form S-1 (See SEC File No. 333-29073).

(2) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended September 30, 2002 (see SEC

File No. 000-22689).

(3) Filed previously as an exhibit to SCM s Registration Statement on Form 8-A (See SEC File No. 000-29440).

(4) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated August 5, 2008 (see SEC File No. 000-22689).

* Denotes management compensatory arrangement.

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