SCM MICROSYSTEMS INC
Form 10-Q
August 14, 2007

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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, 2007
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 or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Yes o No þ

At August 8, 2007, 15,735,615 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,	
	2007	**2006**	**2007**	**2006**
Net revenue	$ 4,647	$ 9,362	$ 13,104	$ 16,789
Cost of revenue	3,314	6,203	8,031	10,980
Gross profit	1,333	3,159	5,073	5,809
Operating expenses:				
Research and development	792	1,061	1,512	2,030
Selling and marketing	1,618	1,922	3,177	3,761
General and administrative	2,879	2,048	4,279	4,132
Amortization of intangible assets	97	165	272	325
Restructuring and other charges (credits)	0	244	0	666
Total operating expenses	5,386	5,440	9,240	10,914
Loss from operations	(4,053)	(2,281)	(4,167)	(5,105)
Interest and other income, net	412	308	720	442
Loss from continuing operations before income taxes	(3,641)	(1,973)	(3,447)	(4,663)
Provision for income taxes	(32)	(18)	(92)	(29)
Loss from continuing operations	(3,673)	(1,991)	(3,539)	(4,692)
Income (loss) from discontinued operations, net of income taxes	(102)	3,948	(119)	3,006
Gain on sale of discontinued operations, net of income taxes	1,530	5,242	1,553	5,263
Net income (loss)	$ (2,245)	$ 7,199	$ (2,105)	$ 3,577
Loss per share from continuing operations:				
Basic and diluted	$ (0.23)	$ (0.13)	$ (0.23)	$ (0.30)
Gain per share from discontinued operations:				
Basic and diluted	$ 0.09	$ 0.59	$ 0.09	$ 0.53
Net income (loss) per share:				
Basic and diluted	$ (0.14)	$ 0.46	$ (0.14)	$ 0.23

Shares used to compute basic and diluted income (loss) per share	15,730	15,627	15,715	15,610
Comprehensive income (loss):				
Net income (loss)	$ (2,245)	$ 7,199	$ (2,105)	$ 3,577
Unrealized gain on investments	(1)	13	10	29
Foreign currency translation adjustment	306	(55)	534	197
Total comprehensive income (loss)	$ (1,940)	$ 7,157	$ (1,561)	$ 3,803

See notes to condensed consolidated financial statements.

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

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 28,516	$ 32,103
Short-term investments	5,972	4,799
Accounts receivable, net of allowances of $429 and $867 as of June 30, 2007 and December 31, 2006	4,398	6,583
Inventories	3,864	1,927
Other current assets	1,335	2,489
Total current assets	44,085	47,901
Property and equipment, net	1,596	1,457
Intangible assets, net		272
Other assets	1,799	1,725
Total assets	$ 47,480	$ 51,355
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,689	$ 4,572
Accrued compensation and related benefits	1,644	1,729
Accrued restructuring and other charges	3,103	3,431
Accrued professional fees	1,009	1,063
Accrued royalties	627	971
Other accrued expenses	2,085	2,289
Income taxes payable	227	1,879
Total current liabilities	11,384	15,934
Long-term income taxes payable	170	
Deferred tax liability	112	103
Commitments and contingencies (see Notes 10 and 11)		
Total liabilities	11,666	16,037
Stockholders equity:		
Common stock, $0.001 par value: 40,000 shares authorized; 16,354 and 16,316 shares issued and 15,736 and 15,698 shares outstanding as of June 30, 2007 and December 31, 2006, respectively	16	16
Additional paid-in capital	229,091	228,580
Treasury stock	(2,777)	(2,777)

Accumulated deficit	(192,273)	(191,714)
Other cumulative comprehensive gain	1,757	1,213
Total stockholders equity	35,814	35,318
Total liabilities and stockholders equity	$ 47,480	$ 51,355

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, 2007	Six Months Ended June 30, 2006
Cash flows from operating activities:		
Net income (loss)	$ (2,105)	$ 3,577
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Gain from discontinued operations	(1,434)	(8,269)
Depreciation and amortization	416	536
Loss (gain) on disposal of fixed assets	(6)	15
Stock compensation expense	407	343
Deferred income taxes	9	(2)
Changes in operating assets and liabilities:		
Accounts receivable	2,148	(933)
Inventories	(1,919)	(1,028)
Other assets	859	(777)
Accounts payable	(1,430)	500
Accrued expenses	(985)	(790)
Income taxes payable	43	204
Net cash used in operating activities from continuing operations	(3,997)	(6,624)
Net cash provided by operating activities from discontinued operations	1,190	8,928
Net cash provided by (used in) operating activities	(2,807)	2,304
Cash flows from investing activities:		
Capital expenditures	(164)	(47)
Maturities of short-term investments	7,699	10,237
Purchase of restricted short-term investments		(2,000)
Purchases of short-term investments	(8,862)	(2,878)
Net cash provided by (used in) investing activities from continuing operations	(1,327)	5,312
Net cash provided by investing activities from discontinued operations		3,484
Net cash provided by (used in) investing activities	(1,327)	8,796
Cash flows from financing activities:		
Proceeds from issuance of equity securities, net	104	117
Net cash provided by financing activities	104	117
Effect of exchange rates on cash and cash equivalents	443	103

Net increase (decrease) in cash and cash equivalents	(3,587)	11,320
Cash and cash equivalents at beginning of period	32,103	13,660
Cash and cash equivalents at end of period	$ 28,516	$ 24,980
Supplemental disclosures of cash flow information:		
Income tax refunds received	$	$ 92
Income taxes paid	$ 45	$
Property and equipment invoices in accounts payable	$ 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, 2007

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulations S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. For further information, refer to the financial statements and footnotes thereto included in SCM Microsystems Inc. s (SCM or the Company) Annual Report on Form 10-K for the year ended December 31, 2006.

During the review of the preparation of the cash flows from discontinued operations for the six months ended June 30, 2007, the Company determined that an adjustment was needed to the condensed consolidated statements of cash flows for the six months ended June 30, 2006. Consequently, in the section Cash flows from operating activities , the amounts in lines Accrued expenses and Net cash used in operating activities from continuing operations were reduced by $2.3 million compared to the condensed consolidated statements of cash flows submitted with Form 10-Q for the quarterly period ended June 30, 2006. Simultaneously, the amount in line Net cash provided (used) in operating activities from discontinued operations was increased by $2.3 million compared to the condensed consolidated statements of cash flows submitted with Form 10-Q for the quarterly period ended June 30, 2006. The adjustment did not have any impact to the cash flows from operating activities in total and was not considered to be material.

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 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* (SFAS 144), for the three and six months ended June 30, 2007 and 2006, 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.

Accounting Changes

During the first quarter of fiscal 2007, the Company adopted the provisions of, and accounted for uncertain tax positions in accordance with the Financial Accounting Standards Board s (FASB) Interpretation No. 48, *Accounting For Uncertain Tax Positions* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption are to be accounted for as an adjustment to the beginning balance of retained earnings.

As a result of the implementation, the Company recognized a $1.5 million decrease to income taxes payable for uncertain tax positions. This decrease was accounted for as an adjustment to the beginning balance of accumulated deficit on the balance sheet. Including this decrease, at the beginning of 2007, the Company had $0.1 million of unrecognized tax benefits included in income taxes payable on the consolidated balance sheet. At June 30, 2007, the Company has $0.2 million of unrecognized tax benefits disclosed in income taxes payable on the consolidated balance sheet. As a result of adoption of FIN 48, unrecognized tax benefits were reclassified to long-term income taxes payable, where applicable.

In addition, $1.6 million of unrecognized tax benefits existed as of January 1, 2007, which do not have any impact on the consolidated balance sheet or income statement, as these only impact the amounts of losses carried forward by the various entities of the Company because any deferred tax assets on these losses carried forward have been fully reserved for. The amount of these unrecognized tax benefits has not changed during the first two quarters of 2007.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of June 30, 2007, approximately $36,000 of accrued interest related to uncertain tax positions.

The Company files U.S. federal, U.S. state and foreign tax returns. The Company is generally no longer subject to tax examinations for years prior to 1999. When loss carry forwards of tax years prior to 1999 would be utilized in the U.S., these tax years also might become subject to investigation by the tax authorities.

While timing of the resolution and/or finalization of audits is very uncertain, the Company does not believe that its unrecognized tax benefits would materially change in the next 12 months.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for the fiscal year beginning January 1, 2008. The Company is currently evaluating the impact of the provisions of SFAS 157 on its financial position, results of operations and cash flows and does not believe the impact of the adoption will be material.

2. Stock Based Compensation

The Company has a stock-based compensation program that provides its Board of Directors discretion in creating employee equity incentives. This program includes incentive and non-statutory stock options under various plans, the majority of which are stockholder approved. Stock options are generally time-based and expire ten years from the grant date. 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 date of grant. Additionally, 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 the ESPP are newly issued shares. The Company s ESPP, director option plan and 1997 stock option plan all expired in March 2007. As of June 30, 2007, the Company had approximately 1.9 million options outstanding and 1.9 million shares of common stock reserved for future issuance upon exercise of those options under all its stock option plans, including those that have expired.

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

The Company elected to use the modified prospective transition method as permitted by SFAS 123(R) and therefore has not restated its financial results for prior periods. Under this transition method, in the three and six months ended June 30, 2007, the compensation cost recognized includes the cost for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. Compensation cost for all share-based compensation awards granted on or subsequent to January 1, 2006 was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation expense from the accelerated multiple-option approach to the straight-line single option method. Compensation expense for all share-based payment awards granted prior to January 1, 2006 will continue to be recognized using the accelerated multiple-option approach, while compensation expense for all share-based payment awards granted on or subsequent to January 1, 2006 has been and will continue to be recognized using the straight-line single-option approach.

Compensation expense recognized in the unaudited condensed consolidated statement of operations for the three and six months ended June 30, 2007, is based on awards ultimately expected to vest and reflects estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to adoption of SFAS 123(R), the Company accounted for forfeitures as they occurred.

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

As a result of adopting SFAS 123(R), for the three and six months ended June 30, 2007, the Company s loss from continuing operations before income tax provision and net loss from continuing operations was $0.3 million and $0.4 million higher, respectively, than if it had continued to account for share-based compensation under Accounting Principles Board Opinion No 25, *Accounting for Stock Issued to Employees* (APB 25). For the three and six months ended June 30, 2006, the Company s loss from continuing operations before income tax provision and net loss from continuing operations was $0.2 million and $0.3 million higher, respectively, than under APB 25. Basic and diluted net loss per share for the three and six months ended June 30, 2007 would have been $0.02 and $0.03 lower, respectively, and basic and diluted net loss per share from continuing operations for the three and six months ended June 30, 2006 would have been $0.01 and $0.02 lower, respectively, if the Company had not adopted SFAS 123(R). There was no effect on the condensed consolidated statements of cash flows for the six months ended June 30, 2007 from adopting SFAS 123(R).

On November 10, 2005, the FASB issued FASB Staff Position No. 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards* (FAS 123(R)-3). The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

The following table illustrates the stock-based compensation expense resulting from stock options and ESPP included in the unaudited condensed consolidated statement of operations for the three- and six-month periods ended June 30, 2007 and 2006 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Cost of revenue	$ 19	$ 8	$ 33	$ 14
Research and development	22	36	45	63
Selling and marketing	70	40	100	82
General and administrative	167	88	229	184
Stock-based compensation expense before income taxes	$ 278	$ 172	$ 407	$ 343
Income tax benefit				
Stock-based compensation expense after income taxes	$ 278	$ 172	$ 407	$ 343

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. A total of 96,792 shares of common stock is reserved for future option grants under the remaining 2000 stock plan as of June 30, 2007.

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Summary of activity under all the Company s stock option plans, including those plans that that expired in March 2007, for the six months ended June 30, 2007 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, 2006	4,084,775	1,783,255	$ 12.58	$ 81,808	5.79
Options granted	(395,301)	395,301	$ 4.04		
Options cancelled or expired	(3,592,682)	(272,113)	$ 8.72		
Options exercised		(10,788)	$ 3.07	$ 8,331	
Balance at June 30, 2007	96,792	1,895,655	$ 11.40	$ 40,195	5.77
Vested or expected to vest at June 30, 2007		1,771,343	$ 11.94	$ 37,603	
Exerciseable at June 30, 2007		1,201,459	$ 15.91	$ 26,089	3.96

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 weighted-average grant date fair value per option for options granted during the three and six months ended June 30, 2006 was $1.88 and $1.84, 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. The total intrinsic value of options exercised during the three and six months ended June 30, 2006 was $149 and $149, 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. Cash proceeds from the exercise of stock options were $800 and $800 for the three and six months ended June 30, 2006, respectively. No income tax benefit was realized from the stock option exercises during the three- and six month periods ended June 30, 2007 and 2006. Stock-based compensation expense related to stock options recognized under SFAS 123(R) for the three and six months ended June 30, 2007 was $0.3 million and $0.4 million, respectively. At June 30, 2007, 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 1.68 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, 2007 and 2006, respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Expected volatility	57%	71%	58%	72%
Dividend yield	0	0	0	0
Risk-free interest rate	4.90%	5.10%	4.73%	4.96%
Expected term (in years)	4.00	3.92	4.00	3.92

Expected Volatility: The Company s computation of expected volatility for the three- and six month periods ended June 30, 2007 is based on the historical volatility of the Company s stock for a time period equivalent to the expected life.

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

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

Expected Term: The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined for the three- and six-month periods ended June 30, 2007 based on historical experience of

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similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior.

1997 Employee Stock Purchase Plan

Until its expiration in March 2007, the Company s ESPP permitted eligible employees to purchase common stock through payroll deductions up to 10% of their base wages at a purchase price of 85% of the lower of fair market value of the common stock at the beginning or end of each offering period. The Company 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 common stock each year. As of June 30, 2007, no shares were available for future issuance under the Company s ESPP, due to the plan s expiration in March 2007.

The fair value of issuances under the Company s ESPP was estimated on the issuance date by applying the principles of FASB Technical Bulletin 97-1 (FTB 97-1), *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look Back Option*, and using the Black-Scholes-Merton options pricing model. Stock-based compensation expense related to the Company s ESPP recognized under SFAS 123(R) for the three and six months ended June 30, 2007 was $0 and a benefit of $40,000, respectively. The benefit in the first quarter of 2007 stemmed from the expiration of the plan before the expected offering periods had terminated. At June 30, 2007, 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 million was paid at the time of sale and $1.6 million was paid in May 2007.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and six months ended June 30, 2006, the DTV solutions business has been presented as discontinued operations in the 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 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 this 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, 2007 and for the same period of 2006 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Net revenue	$	$4,621	$496	$10,411
Operating loss	$(46)	$ (261)	$ (12)	$ (1,161)
Income (loss) before income taxes	$(46)	$3,959	$ 11	$ 3,060
Income tax benefit (provision)	$(16)	$ 23	$ (16)	$ 83
Income (loss) from discontinued operations	$(62)	$3,982	$ (5)	$ 3,143

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, 2007 and for the same period of 2006 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Net revenue	$	$	$	$
Operating loss	$(74)	$(56)	$(154)	$(126)
Net loss before income taxes	$(40)	$(21)	$(114)	$ (83)
Income tax provision	$	$(13)	$	$ (54)
Loss from discontinued operations	$(40)	$(34)	$(114)	$(137)

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4. Short-Term Investments

All of the short-term investment portfolio at June 30, 2007, matures in 2007. The fair value of short-term investments at June 30, 2007 and December 31, 2006 was as follows (in thousands):

	June 30, 2007		
	Amortized Cost	Unrealized Loss on Investments	Estimated Fair Value
Corporate notes	$ 4,972	$ (2)	$ 4,970
U.S. government agencies	1,004	(2)	1,002
Total	$ 5,976	$ (4)	$ 5,972

	December 31, 2006		
	Amortized Cost	Unrealized Loss on Investments	Estimated Fair Value
Corporate notes	$ 1,021	$ (2)	$ 1,019
U.S. government agencies	3,792	(12)	3,780
Total	$ 4,813	$ (14)	$ 4,799

During each quarter, the Company evaluates its investments for possible asset impairment by examining a number of factors, including the current economic conditions and markets for each investment, as well as its cash position and anticipated cash needs for the short and long term. At June 30, 2007, approximately $6.0 million of the short-term investment portfolio had an unrealized loss and approximately $1.0 million of those investments have been in an unrealized loss position for more than one year. Of the $4,000 unrealized loss at June 30, 2007, approximately $2,000 relates to investments that have been in an unrealized loss position for more than one year. The Company believes these fair value declines are the result of rising short-term interest rates. For the three and six months ended June 30, 2007 and 2006, no impairment of the investments was identified based on the evaluations performed.

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5. Inventories

Inventories consist of (in thousands):

	June 30, 2007	December 31, 2006
Raw materials	$ 1,868	$ 754
Work-in-process	177	0
Finished goods	1,819	1,173
Total	$ 3,864	$ 1,927

6. Property and Equipment

Property and equipment consists of (in thousands):

	June 30, 2007	December 31, 2006
Land	$ 138	$ 127
Building and leasehold impovements	1,891	1,789
Furniture, fixtures and office equipment	3,096	2,851
Automobiles	34	1
Purchased software	3,327	3,209
Total	8,486	7,977
Accumulated depreciation	(6,890)	(6,520)
Property and equipment, net	$ 1,596	$ 1,457

Depreciation expense was $0.1 million and $0.1 million for the three- and six-month periods ended June 30, 2007, respectively, and $0.1 million and $0.2 million for the three- and six-month periods ended June 30, 2006, respectively.

7. Intangible Assets

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

		June 30, 2007			December 31, 2006		
	Amortization Period	Gross Carrying Value	Accumulated Amortization	Net	Gross Carrying Value	Accumulated Amortization	Net
Customer relations	60 months	$ 1,685	$ (1,685)	$	$ 1,639	$ (1,520)	$ 119
Core technology	60 months	1,909	(1,909)		1,858	(1,705)	153

Total intangible assets	$3,594	$(3,594)	$	$3,497	$(3,225)	$272

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

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Amortization expense related to intangible assets for continuing operations was $0.1 million and $0.3 million for the three- and six-month periods ended June 30, 2007, respectively, and $0.2 million and $0.3 million for the three- and six-month periods ended June 30, 2006, respectively. No further amounts remain to be amortized in future periods.

8. Restructuring and Other Charges

Continuing Operations

During the three- and six-month periods ended June 30, 2007, SCM incurred net restructuring and other charges related to continuing operations of zero. During the three- and six-month periods ended June 30, 2006, SCM incurred net restructuring and other charges related to continuing operations of approximately $0.3 million and $0.9 million, respectively.

Accrued liabilities related to restructuring actions and other activities during the six months ended June 30, 2007 and during the year ended December 31, 2006 consist of the following (in thousands):

	Lease/Contract Commitments	Severance	Other Costs	Total
Balances as of January 1, 2006	$ 32	$ 152	$ 9	$ 193
Provision for 2006	33	1,320		1,353
Changes in estimates	(2)	4		2
	31	1,324		1,355
Payments and other changes in 2006	(48)	(1,370)		(1,418)
Balances as of December 31, 2006	15	106	9	130
Provision for Q1 2007				
Changes in estimates				
Payments and other changes in Q1 2007	(1)	(101)		(102)
Balances as of March 31, 2007	14	5	9	28
Provision for Q2 2007				
Changes in estimates				
Payments and other changes in Q2 2007	(1)			(1)
Balances as of June 30, 2007	$ 13	$ 5	$ 9	$ 27

During 2006, SCM executed and completed restructuring activities in connection with a reduction in force resulting from the Company s decision to transfer all manufacturing operations from its Singapore facility to contract manufacturers as well as the decision to transfer the corporate headquarter functions of the Company from California to Germany. For the three and six months ended June 30, 2007, no further restructuring costs from continuing operations were incurred.

Discontinued Operations

During the three- and six-month periods ended June 30, 2007, income from restructuring and other items related to discontinued operations was approximately $63,000 and $76,000, respectively. During the three-and six-month periods ended June 30, 2006, SCM incurred restructuring and other charges related to discontinued operations of approximately $75,000 and $56,000, respectively.

Accrued liabilities related to the Digital Media and Video restructuring actions and other activities during the six months ended June 30, 2007 and during the year ended December 31, 2006 consist of the following (in thousands):

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	Lease/Contract Commitments	Other Costs	Total
Balances as of January 1, 2006	$ 3,198	$ 506	$ 3,704
Provision for 2006	2	5	7
Changes in estimates	87		87
	89	5	94
Payments and other changes in 2006	(338)	(159)	(497)
Balances as of December 31, 2006	2,949	352	3,301
Provision for Q1 2007			
Changes in estimates	(13)		(13)
	(13)		(13)
Payments and other changes in Q1 2007	(92)	4	(88)
Balances as of March 31, 2007	2,844	356	3,200
Provision for Q2 2007			
Changes in estimates	(23)	(40)	(63)
	(23)	(40)	(63)
Payments and other changes in Q2 2007	(66)	5	(61)
Balances as of June 30, 2007	$ 2,755	$ 321	$ 3,076

9. Segment Reporting, Geographic Information and Major Customers

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

The Company s continuing operations provide secure digital access solutions to mainly OEM customers in two markets segments: PC Security and Flash 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 profit 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, 2007 and during the same periods of 2006 is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
PC Security:				
Net revenue	$3,864	$6,788	$10,960	$11,341
Gross profit	1,256	2,946	$ 4,499	4,859
Gross profit %	33%	43%	41%	43%
Flash Media Readers				
Net revenue	$ 783	$2,574	$ 2,144	$ 5,448
Gross profit	77	213	$ 574	950
Gross profit %	10%	8%	27%	17%
Total:				
Net revenue	$4,647	$9,362	$13,104	$16,789
Gross profit	1,333	3,159	5,073	5,809
Gross profit %	29%	34%	39%	35%

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,	
	2007	2006	2007	2006
Net revenue				
United States	$ 2,140	$ 4,151	$ 5,939	7,165
Europe	1,705	4,211	4,113	$ 7,166
Asia-Pacific	802	1,000	3,052	2,458
Total	$ 4,647	$ 9,362	$ 13,104	$ 16,789
% of net revenue				
United States	46%	44%	46%	43%
Europe	37%	45%	31%	43%
Asia-Pacific	17%	11%	23%	14%

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Customer A based in the USA	13%	14%	13%	11%
Customer B based in Asia	11%	*	*	*
Customer C based in Europe	*	15%	*	10%
Customer D based in the USA	*	*	15%	*
Customer E based in Asia	*	*	11%	*

Totals	24%	30%	39%	21%

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

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

	June 30, 2007	December 31, 2006
Customer A based in the USA	23%	17%
Customer B based in the USA	17%	*
Customer C based in Asia	*	19%
Total	40%	36%

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

Long-lived assets by geographic location as of June 30, 2007 and December 31, 2006, are as follows (in thousands):

	June 30, 2007	December 31, 2006
Property and equipment, net:		
United States	$ 20	$ 27
Europe	218	150
Asia-Pacific	1,358	1,280
Total	$ 1,596	$ 1,457

10. Commitments

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

Purchases for inventories are highly dependent upon forecasts of the customers demand. Due to the uncertainty in demand from its customers, the Company may have to change, reschedule, or cancel purchases or purchase orders from its suppliers. These changes may lead to vendor cancellation charges on these purchases or contractual commitments. As of June 30, 2007, total purchase and contractual commitments were approximately $2.8 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, 2007 and 2006 were as follows (in thousands):

	2007	2006
Balances at January 1	$ 34	$ 153
Additions related to sales during the period	31	45
Warranty costs incurred during the period	(27)	(43)
Adjustments to accruals related to prior period sales	(7)	(98)
Adjustments to accruals related to sale of the DTV Solutions business		(28)
Balances at June 30	$ 31	$ 29

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):

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	For the Three months Ended June 30,		For the Six months Ended June 30,	
	2007	2006	2007	2006
Net loss from continuing operations	$ (3,673)	$ (1,991)	$ (3,539)	$ (4,692)
Income from discontinued operations	1,428	9,190	1,434	8,269
Net income (loss)	$ (2,245)	$ 7,199	$ (2,105)	$ 3,577
Weighted average common shares outstanding used in income (loss) per common share - basic and diluted	15,730	15,627	15,715	15,610
Net income (loss) per common share - basic and diluted				
Continuing operations	$ (0.23)	$ (0.13)	$ (0.23)	$ (0.30)
Discontinued operations	$ 0.09	$ 0.59	$ 0.09	$ 0.53
Net income (loss) per common share - basic and diluted	$ (0.14)	$ 0.46	$ (0.14)	$ 0.23

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.

The computation of diluted net income per common share for the three and six months ended June 30, 2006, excludes the effect of the potential exercise of options to purchase approximately 26,000 and 28,000 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, 2006 also excludes the effect of the potential exercise of options to purchase approximately 2.4 million and 2.5 million shares, respectively, because the option exercise price was greater than the average market price of the common shares and the effect would have been anti-dilutive.

12. Legal Proceedings

From time to time, SCM could be subject to claims arising in the ordinary course of business or could 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 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

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

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

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 into two market segments: PC Security and Flash Media Readers.

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

For the Flash Media 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 electronics and photographic equipment manufacturers for our digital media readers. We sell and license our products through a direct sales and marketing organization, as well as through distributors, value added resellers and systems integrators worldwide.

On May 22, 2006 we completed the sale of our Digital Television solutions (DTV 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.)

In our continuing operations, we have experienced significant variations in demand for our products quarter to quarter. In our PC Security business, variations in demand are primarily the result of timing of orders associated with 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. In our Flash Media Reader business, variability in demand is primarily the result of our dependence on a small number of customers in this business, which can result in significant fluctuation in sales levels from one period to another. Two customers have historically accounted for approximately 65% of revenues in our Flash Media Reader business.

We have adopted a strategy to grow revenue that is based on introducing new PC Security and Flash Media Reader products to address emerging market opportunities. During 2006 and in the first quarter of 2007, we experienced increased demand for our smart card readers, primarily from the government sector, where we began to provide readers for new and emerging programs such as e-passports and e-healthcare. In the second quarter of 2007, sales of our smart card readers were negatively impacted by budget freezes in the U.S. government sector, which contributed to delayed orders, demand fluctuations with a major customer in Asia and project delays in various European smart card security programs. While we believe that enterprise security projects and e-passport and other government authentication programs will continue to grow in the future and that we will continue to play an active role in providing smart card readers to these programs, it is very difficult to estimate the level or timing of demand in any given period.

In addition, in the second quarter of 2007 we experienced significantly reduced orders from one of our two major Flash Media Reader customers due to significantly reduced demand in their end markets. We believe that sales in our Flash Media Reader business will increase from second quarter levels in the second half of 2007, as we have recently begun to build backlog with this customer. However, orders from this customer may not return to historic levels and this business remains subject to significant variability in terms of the timing of orders in any given period.

In both our PC Security and Flash Media Reader businesses, pricing pressure has increased over the last several quarters. To address an increasingly competitive environment, during 2006 we put in place cost reduction programs that, beginning in the fourth quarter of 2006 and continuing into the second quarter of 2007, have resulted in improvements to gross product margin. In the second quarter of 2007, this improvement was largely offset by significantly lower sales levels.

During late 2005 and throughout 2006, we implemented a number of measures to reduce operating expenses, including the outsourcing of our manufacturing operations and the consolidation of facilities and functions. The full effect of our cost cutting actions was first experienced in the fourth quarter of 2006, when our GAAP operating expenses decreased from an average of $5.7 million for the first three quarters of fiscal 2006 to $3.5 million in the fourth quarter. Through the first six months of 2007, our expenses for research and development, sales and marketing, and general and administrative have remained under $4.0 million per quarter, with the exception of a $1.4 million charge taken in general and administrative expenses in the second quarter of 2007 for severance and other costs associated with the resignation of Robert Schneider, our former CEO.

Critical Accounting Policies and Estimates

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

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

We recognize product revenue upon shipment provided that risk and title have transferred, a purchase order has been received, collection is determined to be reasonably assured and no significant obligations remain.

Maintenance revenue is deferred and amortized over the period of the maintenance contract. Provisions for estimated warranty repairs and returns and allowances are provided for at the time products are shipped. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances 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 Financial Accounting Standards Board s (FASB) Interpretation No. 48, *Accounting For Uncertain Tax Positions* (FIN 48) in the first quarter of 2007. See Note 1 in the Notes to Consolidated Financial Statements of this Form 10-Q for further discussion. 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, 2007 we have recorded valuation allowances against substantially all of our deferred tax assets. The deferred tax assets are still available for us to use in the future to offset taxable income, which would result in the recognition of a tax benefit and a reduction in our effective tax rate. 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 September 2006, FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about

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fair value measurements. The provisions of SFAS 157 are effective for the fiscal year beginning January 1, 2008. We are currently evaluating the impact of the provisions of SFAS 157 on our financial position, results of operations and cash flows and do not believe the impact of the adoption will be material.

Results of Operations

Net Revenue. Summary information by product segment for the three- and six-month periods ended June 30, 2007 and 2006 is as follows (in thousands):

	Three months ended June 30, 2007	Three months ended June 30, 2006	% change period to period	Six months ended June 30, 2007	Six months ended June 30, 2006	% change period to period
PC Security						
Revenue	$3,864	$6,788	(43)%	$10,960	$11,341	(3)%
Gross profit	1,256	2,946		4,499	4,859	
Gross profit %	33%	43%		41%	43%	
Flash Media Readers						
Revenue	$ 783	$2,574	(70)%	$ 2,144	$ 5,448	(61)%
Gross profit	77	213		574	950	
Gross profit %	10%	8%		27%	17%	
Total:						
Revenue	$4,647	$9,362	(50)%	$13,104	$16,789	(22)%
Gross profit	1,333	3,159		5,073	5,809	
Gross profit %	29%	34%		39%	35%	

Net revenue for the three months ended June 30, 2007 was $4.6 million, down 50% compared to $9.4 million for the same period of 2006. This decrease in revenue resulted from lower sales across our business segments due to a variety of factors, which are discussed below. For the six months ended June 30, 2007, net revenue was $13.1 million, down 22% from revenue of $16.8 million in the first six months of 2006. The decrease in revenue in the six-month period resulted primarily from lower sales of our Flash Media Reader products.

Our PC Security product line consists of smart card readers and related chip technology that are utilized principally in security programs where smart cards are used to authenticate the identity of people in order to control access to computers, computer networks, borders, buildings and other facilities. Revenue in this product line is typically tied to large security projects of governments, financial institutions or enterprises and is subject to significant variability based on the size and timing of customer orders. The timing of any new projects that may create or increase demand for smart card readers is unpredictable. In our PC Security product line, sales were $3.9 million in the second quarter of 2007, a decrease of 43% from sales of $6.8 million in the second quarter of 2006. Significantly lower sales levels in the second quarter of 2007 compared with the prior year resulted from lower product orders across all geographies. In the U.S., budget freezes in the federal government sector resulted in significantly lower orders than in recent periods. In Europe, sales were affected by delays in a number of projects for which we had anticipated we would ship readers. In Japan, product orders from a major customer have been delayed. In all three geographies, we believe that the reduced sales levels we experienced in the second quarter of 2007 reflect variability in the timing of orders, rather than loss of business to competition or lack of long-term growth potential in the market for smart card readers. For the first six months of 2007, sales in our PC Security business were $11.0 million, down 3% from $11.3 million for the first six months of 2006.

Flash Media Reader revenues consist of sales of digital media readers to provide an interface for flash memory cards, primarily for digital photography kiosks, where our products are used to download and print digital photos. Two customers have historically accounted for approximately 65% of our sales in this business segment. As a result, revenue in our Flash Media Reader product line can fluctuate significantly quarter to quarter due to variability in the size and timing of customer orders. Revenue from our Flash Media Reader product line was $0.8 million in the second quarter of 2007, a decrease of 70% from $2.6 million in the second quarter of 2006. For the first six months of 2007, sales were $2.1 million, down 61% compared with $5.4 million in the first six months of 2006. The decrease in Flash Media Reader sales in both the second quarter and the first six months of 2007 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 as a result of significantly reduced demand in their end markets.

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Gross Profit. Gross profit for the second quarter of 2007 was $1.3 million, or 29% of revenue, compared to $3.2 million, or 34% of revenue in the same period of 2006.

Gross profit for our PCS Security products was 33% for the second quarter of 2007 compared with 43% for the second quarter of 2006. The decrease in gross profit in the second quarter of 2007 compared with the same period of 2006 primarily resulted from lower sales levels in the 2007 period, as a portion of our supply chain expenses included in cost of revenue are fixed.

Gross profit for our Flash Media Reader products was 10% for the second quarter of 2007, compared with 8% for the second quarter of 2006. Low gross margins in both periods primarily reflect low sales levels in the respective periods.

For the first six months of 2007, gross profit was $5.1 million, or 39% of revenue, compared with $5.8 million, or 35% of revenue for the first six months of 2006. The improvement in gross profit margin in the first six months of 2007 compared with the prior year is in part due to a more favorable mix of higher margin products, better inventory management and product cost reductions in our PC Security business, offset by lower sales levels across our businesses in the second quarter of 2007. In addition, gross profit for the first six months of 2006 was adversely impacted by approximately $0.2 million in severance costs related to the outsourcing of our Singapore manufacturing operations to contract manufacturers as well as $0.4 million of net inventory write-downs.

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

Research and Development.

	Three months ended June 30		% change period to period	Six months ended June 30		% change period to period
	2007	2006		2007	2006	
Expenses	$ 792	$ 1,061	(25)%	$ 1,512	$ 2,030	(26)%
Percentage of total revenues	17%	11%		12%	12%	

Research and development expenses consist primarily of employee compensation and fees for the development of prototype products. Research and development costs are primarily related to hardware and firmware development. For the second quarter of 2007, research and development expenses were $0.8 million, or 17% of revenue, compared with $1.1 million, or 11% of revenue in the second quarter of 2006. For the first six months of 2007, research and development expenses were $1.5 million, or 12% of revenue, compared with $2.0 million, or 12% of revenue for the first six months of 2006. Lower research and development expenses in the second quarter and first six months of 2007 compared with the prior year are primarily due to a lower level of external resources used.

Selling and Marketing.

	Three months ended June 30		% change period to period	Six months ended June 30		% change period to period
	2007	2006		2007	2006	
Expenses	$ 1,618	$ 1,922	(16)%	$ 3,177	$ 3,761	(16)%
Percentage of total revenues	35%	21%		24%	22%	

Selling and marketing expenses consist primarily of employee compensation as well as tradeshow participation and other marketing costs. Selling and marketing expenses in the second quarter of 2007 were $1.6 million, or 35% of revenue, compared with $1.9 million, or 21% of revenue in the second quarter of 2006. For the first six months of 2007, sales and marketing expenses were $3.2 million, compared with $3.8 million in the first six months of 2006. We expect our sales and marketing costs will vary as we continue to align our resources to address existing and new market opportunities.

General and Administrative.

	Three months ended June 30		**% change period to period**	**Six months ended June 30**		% change period to period
	2007	**2006**		**2007**	**2006**	
Expenses	$2,879	$2,048	41%	$4,279	$4,132	4%
Percentage of total revenues	62%	22%		33%	25%	

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

2007, general and administrative expenses were $2.9 million, or 62% of revenue, compared with $2.0 million, or 22% of revenue in the second quarter of 2006. Included in the second quarter of 2007 are severance and other costs associated with the resignation of Robert Schneider, our former CEO, totaling $1.4 million. For the first six months of 2007, general and administrative expenses were $4.3 million, including the $1.4 million in severance and other costs associated with the resignation of our CEO, compared with $4.1 million in the first six months of 2006. The reduction in our underlying general and administrative expenses in the second quarter and first six months of 2007, excluding the $1.4 million in severance and other costs for our former CEO, compared with the prior year primarily related to the consolidation and transfer of our corporate finance and compliance functions from the U.S. to Germany and the transfer of local finance functions from Singapore and the U.S. to Germany at the end of 2006.

Amortization of Intangibles. Amortization of intangibles was $0.1 million during the second quarter of 2007 compared with $0.2 million during the second quarter of 2006. For the first six months of 2007 and 2006, amortization of intangibles was $0.3 million. No further amounts remain to be amortized in future periods.

Restructuring and Other Charges (Credits). We did not incur any restructuring or other charges during the first six months of 2007. For the three and six months ended June 30, 2006, we recorded restructuring and other charges of $0.2 million and $0.7 million, respectively, primarily related to severance costs for general and administrative personnel that were affected by our decision to relocate certain corporate headquarter functions in California to Germany as well as the process of outsourcing our manufacturing operations from our Singapore facility to contract manufacturers. Severance costs for manufacturing personnel were recorded in cost of revenue.

Interest and Other Income: Interest and other income, net consists of interest earned on invested cash, other income and expense and foreign currency gains or losses. In the second quarter of 2007 interest income resulting from invested cash balances was $0.4 million, compared with interest income of $0.3 million for the second quarter of 2006. In the first six months of 2007, interest income was $0.7 million, compared with interest income of $0.6 million in the first six months of 2006.

Foreign currency transaction losses and other expense were zero in both the second quarter of 2007 and the second quarter of 2006. Foreign currency transaction losses and other expense were $0.1 million in both the first six months of 2007 and the first six months of 2006.

Income Taxes. In the three and six months ended June 30, 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.

We recorded a tax provision of $18,000 and $29,000, respectively, in the three and six months ended June 30, 2006, primarily resulting from taxes payable in foreign jurisdictions which are not offset by operating 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 the three and six months ended June 30, 2007 was $0 and $0.5 million, respectively. Net revenue for the DTV solutions business in the three and six months ended June 30, 2006 was $4.6 million and $10.4 million, 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. Operating loss for the DTV solutions business for the three and six months ended June 30, 2006 was $0.3 million and $1.2 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 $0 in each of the three- and six-month periods ended June 30, 2007 and 2006. Operating loss for the retail Digital Media and Video business was $0.1 million and $0.2 million in the three- and six-month periods ended June 30, 2007, respectively and operating loss for the retail Digital Media and Video business was $0.1 million in both the three- and six-month periods ended June 30, 2006, respectively.

In May 2007, we received an adjusted 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 three months ended June 30, 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 the three and six months ended June 30, 2006, net gain on the disposal of discontinued operations was approximately $5.2 million and $5.3 million, respectively.

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Liquidity and Capital Resources

As of June 30, 2007, our working capital, which we have defined as current assets less current liabilities, was $32.7 million, compared to $32.0 million as of December 31, 2006, an increase of approximately $0.7 million. The rise in working capital for the first six months of 2007 primarily reflects the decrease in current liabilities of $4.6 million, offset in part by lower cash and cash equivalents and short-term investments of $2.4 million and a $ 1.4 million reduction resulting from the combined development of accounts receivable, inventories and other current assets.

Cash and cash equivalents and short-term investments were $34.5 million as of June 30, 2007, a decrease of approximately $2.4 million compared to the balance of $36.9 million as of December 31, 2006.

The following summarizes our cash flows for the six months ended June 30, 2007 (in thousands):

		Six Months Ended June 30, 2007
Operating cash used in continuing operations	$	(3,997)
Operating cash provided by discontinued operations		1,190
Investing cash used		(1,327)
Financing cash flow		104
Effect of exchange rate changes on cash and cash equivalents		443
Decrease in cash and cash equivalents		(3,587)
Cash and cash equivalents at beginning of period		32,103
Cash and cash equivalents at end of period	$	28,516

During the first six months of 2007, cash used in operating activities was $2.8 million. Net loss of $2.1 million and the cash use of approximately $1.3 million from changes in operating assets and liabilities was partly offset by cash flow adjustments for depreciation, amortization and stock compensation totaling $0.8 million, as well as cash provided in operating activities from discontinued operations, which resulted primarily from the $1.6 million payment from Kudelski received in the second quarter of 2007 in connection with the sale of our DTV solutions business to Kudelski in 2006.

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 $5.5 million and inventory and other purchase commitments were approximately $2.8 million at June 30, 2007.

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 2007. 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 used in investing activities for the six months ended June 30, 2007, was primarily for purchases of short-term investments of $8.9 million, offset by maturities of $7.7 million.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no significant change in our exposure to market risk during the first six months of 2007. 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, 2006.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our acting principal executive officer, who is also our principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of June 30, 2007. Based on this evaluation, our acting principal executive officer, who is also our principal financial officer, concluded that our disclosure controls and procedures were effective as of June 30, 2007, such that the information relating to our business and operations, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission (SEC) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls

In connection with our continued monitoring and maintenance of our controls procedures in relation to the provisions of Sarbanes-Oxley, 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 2007 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

Any of the 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 $192.3 million as of June 30, 2007. We may continue to incur losses in the future and may be unable to achieve or maintain profitability.

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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;
- our backlog and inventory levels;
- our customer and distributor inventory levels and product returns;
- competition;
- new product announcements or introductions;
- our ability to develop, introduce and market new products and product enhancements on a timely basis, if at all;
- our ability to successfully market and sell products into new geographic or 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 in demand for our products resulting from fluctuations in

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our customers deployment schedules as they implement smart card-based programs. 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 photography and computer industries, as well as the government sector and corporate enterprises. Sales to a relatively small number of customers historically have accounted for a significant percentage of our revenues. Sales to our top ten customers accounted for approximately 61% of revenue in the first six months of 2007 and 53% of revenue in fiscal 2006. We expect that sales of our products to a relatively small number of customers will continue to account for a high percentage of our total sales for the foreseeable future, particularly in our Flash Media Reader business, where two customers have historically accounted for approximately 65% of our business. The loss of a customer or reduction of orders from a significant customer, including those due to product performance issues, changes in customer buying patterns, or market, economic or competitive conditions in our market segments, could significantly

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lower our revenues in any period and would increase our dependence on a smaller group of our remaining customers. For example, in the second quarter of 2007, we experienced a significant reduction in sales of our Flash Media Reader products due to a significant reduction in orders from one of our two major customers in this business, as the result of significantly reduced demand in the customer s end markets. 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.

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 e-passport programs in Europe and for authentication of personnel within various U.S. government agencies, both of which are new applications that are not yet widely implemented. If demand for products for applications such as these does not develop further and grow sufficiently, our revenue and gross profit margins could decline or fail to grow. For example, in the second quarter of 2007 we experienced lower sales of our smart card reader products in Europe as a result of delays in smart card programs such as e-passport. We cannot predict the future growth rate, if any, or 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 adoption of smart cards by the U.S. and other governments, European banks and other enterprises for large scale security programs beyond those in place today;

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

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

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

Products such as our smart card readers and digital media readers may contain defects for many reasons, including defective design 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.

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

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

We rely upon a limited number of suppliers of several key components of our products. For example, we currently utilize the foundry services of Atmel and Samsung to produce our ASICs for smart cards readers; we use chips and antenna components from Philips in our contactless smart card readers; and we use various mechanical components in our smart card readers from TaiSol Electronics. 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. This could result in components not being available to us in a timely manner or at all, particularly if larger companies have ordered more significant volumes of those components, or in higher prices being charged for components. Disruption or termination of the supply of components or software used in our products could delay shipments of these products. These delays could have a material adverse effect on our business and operating results and could also damage relationships with current and prospective customers.

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

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

Our future success will depend upon our ability to enhance our current products and to develop and introduce new products with clearly differentiated benefits that address the increasingly sophisticated needs of our customers and that keep pace with technological developments, new competitive product offerings and emerging industry standards. We must be able to demonstrate that our products have features or functions that are clearly differentiated from existing or anticipated competitive offerings, or we may be unsuccessful in selling these products. In addition, in cases where we are selected to supply products based on features or capabilities that are still under development, we must be able to complete our product design and delivery process on a timely basis, or risk losing current and any future revenue from those products. In developing our products, we must collaborate closely with our customers, suppliers and other strategic partners to ensure that critical development, marketing and distribution projects proceed in a coordinated manner. Also, this collaboration is important because these relationships increase our exposure to information necessary to anticipate trends and plan product development. If any of our current relationships terminate or otherwise deteriorate, or if we are unable to enter into future alliances that provide us with comparable insight into market trends, our product development and marketing efforts may be adversely affected, and we could lose sales. We expect that our product development efforts will continue to require substantial investments and we may not have sufficient resources to make the necessary investments.

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

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

Our markets are highly competitive.

The markets for our products are 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;

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- the extent to which standards are widely adopted and product interoperability is required within industry segments;
- the extent to which products are differentiated based on technical features, quality and reliability, ease of use, strength of distribution channels and price; and
- the ability of suppliers to develop new products quickly to satisfy new market and customer requirements.

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

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

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

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

Historically, we have sold a significant proportion of our smart card reader products to the U.S. government and we anticipate that some portion of our future revenues will also come from this sector. The timing of U.S. government smart card projects is not always certain. For example, budget freezes during the second quarter of 2007 resulted in delayed orders for our smart card reader products. While the U.S. government has announced plans for several new smart card-based security projects, few have yet reached a stage of sustained high volume card or reader deployment, in part due to delays in reaching agreement on specifications for a new federally mandated set of identity credentials. In addition, government expenditures on IT projects have varied in the past and we expect them to vary in the future. As a result of shifting priorities in the federal budget and in the Department of Homeland Security, U.S. government spending may be reallocated away from IT projects, such as smart card deployments. The slowing or delay of government projects for any reason could negatively impact our sales.

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

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

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

To achieve a quorum at a regular or special stockholder meeting, at least one-third of all shares of our stock entitled to vote must be present at such a meeting in person or by proxy. As of August 7, 2006, the record date for our 2006 Annual Meeting of Stockholders, more than two-thirds of our shares outstanding were held by retail stockholders in Germany, through German banks

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and brokers. Securities regulations and customs in Germany result in very few German banks and brokers providing our proxy materials to our stockholders in Germany and in very few German stockholders voting their shares even when they do receive such materials. In addition, the absence of a routine broker non-vote in Germany typically requires the stockholder to return the proxy card to us before the votes it represents can be counted for purposes of establishing a quorum.

We expect that a significant percentage of our shares will continue to be held by retail stockholders in Germany through German banks and brokers. As a result, it is difficult and costly for us, and requires considerable management resources, to achieve a quorum at annual and special meetings of our stockholders, if we are able to do so at all. For example, because of the large pool of shares in Germany that were not voted, we had to adjourn our 2006 Annual Meeting of Stockholders from its original date of October 6, 2006, until November 3, 2006, in order to solicit enough votes to achieve quorum. This resulted in additional cost and diversion of management resources from our operations. We 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.

Our 2007 Annual Meeting of Stockholders has been delayed until November 2007. If we are unable to achieve quorum for this meeting, we will have very little time to adjourn the meeting and solicit stockholder proxies before the end of the calendar year. The future failure to hold an annual meeting of stockholders may result in our being out of compliance with Delaware law and the qualitative listing requirements of the NASDAQ Stock Market, each of which requires us to hold an annual meeting of our stockholders. Our inability to obtain a quorum at any such meeting may not be an adequate excuse for such failure. In accordance with Section 211 of the Delaware General Corporation Law, if there has been a failure to hold an annual meeting, the Court of Chancery may order a meeting to be held upon the application of any stockholder or director. Lack of compliance with the qualitative listing requirements of the NASDAQ Stock Market could result in the delisting of our common stock on the NASDAQ Stock Market. Either of these events would divert management s attention from our operations and would likely be costly and could also have an adverse effect on the trading price of our common stock.

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

Our business model includes the management of separate product lines that address disparate market opportunities that are geographically dispersed. While there is some shared technology across our products, each product line requires significant research and development effort to address the evolving needs of our customers and markets. To support our development and sales efforts, we maintain company offices and business operations in several locations around the world, including Germany, India, Japan and the United States. We also must manage contract manufacturers in Singapore and China. 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.

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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 55% of our revenue for the first six months of 2007 and approximately 57% of our revenue for the year ended December 31, 2006 were derived from customers located outside the United States. Because a significant number of our principal customers are located in other countries, we anticipate that international sales will continue to account for a substantial portion of our revenues. As a result, a significant portion of our sales and operations may continue to be subject to risks associated with foreign operations, any of which could impact our sales and/or our operational performance. These risks include, but are not limited to:

- changes in foreign currency exchange rates;
- changes in a specific country s or region s political or economic conditions and stability, particularly in emerging markets;
- unexpected changes in foreign laws and regulatory requirements;
- potentially adverse tax consequences;
- longer accounts receivable collection cycles;
- difficulty in managing widespread sales and manufacturing operations; and
- less effective protection of intellectual property.

Fluctuations in the valuation of foreign currencies could result in currency exchange 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. We cannot predict the effect of exchange rate fluctuations upon future quarterly and annual operating results. We may experience currency losses in the future. To date, we have not adopted a hedging program to protect us from risks associated with foreign currency fluctuations.

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

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

We also believe that our future success will depend in large part on our ability to attract and retain highly qualified technical and management personnel. However, competition for such personnel is intense. We may not be able to retain our key technical and management employees or to attract, assimilate or retain other highly qualified technical and management personnel in the future. At the end of June 2007, our chief executive officer resigned from the Company and our chief financial officer took on the additional role of acting chief executive officer. In late July 2007, we signed an employment agreement with an individual who is to become our new CEO in November 2007. If the new CEO further delays his start date with us or does not ultimately join the Company, our business could be harmed as further management time and attention would be required to manage the CEO function and our strategic planning process could be delayed.

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. Our CEO resigned from the Company and as a director in June 2007 and one of our current directors has informed us that he does not intend to stand for reelection to the Board at our next Annual Meeting. In the absence of new appointments to the Board, these changes will reduce the number of directors on our Board to five in November 2007. If we are not able to attract and retain qualified board members, our ability to practice a high a level of corporate governance could be impaired.

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

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

We face risks associated with strategic transactions.

A component of our ongoing business strategy is to seek to buy businesses, products and technologies that complement or augment our existing businesses, products and technologies. We have in the past acquired or made, and from time to time in the future may acquire or make, investments in companies, products and technologies that we believe are complementary to our existing businesses, products and technologies. Any future acquisition could expose us to significant risks, including, without limitation, the use of our limited cash balances or potentially dilutive stock offerings to fund such acquisitions; costs of any necessary financing, which may not be available on reasonable terms or at all; accounting charges we might incur in connection with such acquisitions; the difficulty and expense of integrating personnel, technologies, customer, supplier and distributor relationships, marketing efforts and facilities acquired through acquisitions; diversion of our management resources; failure to realize anticipated benefits; costly fees for legal and transaction-related services; and the unanticipated assumption of liabilities. Any of the foregoing could have a material adverse effect on our financial condition and results of operations. We 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 divestiture or disposition. In addition, any such divestiture or disposition could result in our recognition of an operating loss to the extent that the proceeds received by us in the divestiture or disposition are less than the book value of the assets sold. 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 generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the Financial Standards Accounting Board, the American Institute of Certified Public Accountants, the Securities and Exchange Commission and various other bodies formed to interpret and create appropriate accounting rules and policies. A change in those rules or policies could have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. For example, under the recently issued Financial Accounting Standard Board Statement No. 123(R) (FAS 123(R)), as of January 1, 2006 we were required to apply certain expense recognition provisions to share-based payments to employees using the fair value method. Adoption of SFAS 123R resulted in our recording stock option compensation expense of $0.4 million in the first six months of 2007. Any other changes in accounting policies in the future may also result in significant accounting charges. See Note 2 to our consolidated financial statements attached to the Annual Report on Form 10-K for the expense disclosures under SFAS No. 123R.

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

Under Section 302 of the Sarbanes-Oxley Act of 2002, on a quarterly basis our management is required to make certain certifications regarding our disclosure controls and internal controls over financial reporting. The process of maintaining and evaluating the effectiveness of these controls is expensive, time-consuming and requires significant attention from our management and staff. We have found 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 discover material weaknesses that we would then be required to disclose. We may not be able to accurately or timely report on our financial results, and we might be subject to investigation by regulatory authorities. As a result, the financial position of our business could be harmed; current and potential future shareholders could lose confidence in us and/or our reported financial results, which may cause a negative effect on the trading price of our common stock; and we could be exposed to litigation or regulatory proceedings, which may be costly or divert management attention.

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

We face risks from litigation.

From time to time, we may be subject to litigation, which could include claims regarding infringement of the intellectual property rights of third parties, product defects, employment-related claims, and claims related to acquisitions, dispositions or restructurings. For example, in December 2005, a complaint was filed in France against SCM Microsystems GmbH, one of our wholly-owned subsidiaries, by Aston France S.A. alleging participation by SCM Microsystems GmbH in the counterfeiting of Aston s conditional access modules and claiming damages in the amount of approximately $69 million. While this claim was subsequently withdrawn, 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 our acquisition by another company, which could decrease the value of your shares.

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us or enter into a material transaction with us without the consent of our Board of Directors. These provisions include a classified Board of Directors and limitations on actions by our stockholders by written consent. Delaware law imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. In addition, our Board of Directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

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

These provisions will apply even if the offer were to be considered adequate by some of our stockholders. Also, because these provisions may be deemed to discourage a change of control, they could decrease the value of our common stock.

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 8, 2007, 15,735,615 shares of common stock were outstanding.

As of June 30, 2007, we had approximately 0.1 million shares of common stock reserved for future issuance under our 2000 stock option plan and 1.9 million shares of common stock were subject to outstanding options under our 2000 stock plan and our now expired 1997 and director stock plans. We may also issue additional shares of our common stock or other securities that are convertible into or exercisable for 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 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

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

None

Item 5. Other Information.

In addition to the resignation of our CEO, a director of the Company, from the Company and our Board of Directors in June 2007, one of our current directors has informed us that he does not intend to stand for reelection to the Board at our 2007 Annual Meeting of Stockholders. In the absence of new appointments to the Board, these changes will reduce the number of directors on our Board to five as in November 2007.

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

	Registrant
	SCM MICROSYSTEMS, INC.
August 14, 2007	/s/ Stephan Rohaly Stephan Rohaly Chief Financial Officer and Secretary and Acting Chief Executive Officer

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EXHIBIT INDEX

Exhibit Number	Description of Document
3.1(1)	Fourth Amended and Restated Certificate of Incorporation.
3.2(5)	Amended and Restated Bylaws of Registrant.
3.3(6)	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(6)	Preferred Stock Rights Agreement, dated as of November 8, 2002, between SCM Microsystems, Inc. and American Stock Transfer and Trust Company.
10.1(1)*	Form of Director and Officer Indemnification Agreement.
10.2(8)*	Amended 1997 Stock Plan.
10.3(1)*	1997 Employee Stock Purchase Plan.
10.4(1)*	1997 Director Option Plan.
10.5(1)*	1997 Stock Option Plan for French Employees.
10.6(1)*	1997 Employee Stock Purchase Plan for Non-U.S. Employees.
10.7(2)*	2000 Non-statutory Stock Option Plan.
10.8(2)*	Dazzle Multimedia, Inc. 1998 Stock Plan.
10.9(2)*	Dazzle Multimedia, Inc. 2000 Stock Option Plan.
10.10(3)	Sublease Agreement, dated December 14, 2000 between Microtech International and Golden Goose LLC.
10.11(1)*	Form of Employment Agreement between SCM Microsystems GmbH and Robert Schneider.
10.12(4)	Tenancy Agreement dated August 31, 2001 between SCM Microsystems GmbH and Claus Czaika.
10.13(11)	Shuttle Technology Group Unapproved Share Option Scheme.
10.14(12)*	Form of Employment Agreement between SCM Microsystems GmbH and Colas Overkott.

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Exhibit Number	Description of Document
10.15(13)*	Description of Executive Compensation Arrangement.
10.16(14)*	Management by Objective (MBO) Bonus Program Guide.
10.17(15)*	Bonus Agreement between SCM Microsystems and Colas Overkott dated January 13, 2006.
10.18(15)*	Separation Agreement between SCM Microsystems and Colas Overkott dated January 13, 2006.
10.19(15)*	Employment Agreement between SCM Microsystems and Steven L. Moore dated January 17, 2006.
10.20(15)*	Separation Agreement between SCM Microsystems and Ingo Zankel dated January 27, 2006.
10.21(15)*	Employment Agreement between SCM Microsystems and Stephan Rohaly dated March 14, 2006.
10.22(16)	Purchase Agreement between SCM Microsystems and Kudelski S.A.
10.23(17)*	Restrictive Covenant between Kudelski S.A. and Robert Schneider dated May 22, 2006.
10.24(17)*	Amended Employment Agreement between SCM Microsystems GmbH and Robert Schneider dated May 22, 2006.
10.25(17)*	Amended Employment Agreement between SCM Microsystems GmbH and Dr. Manfred Mueller dated June 8, 2006.
10.26(16)	Lease dated July 15, 2006 between SCM Microsystems and Rreef America Reit II Corp.
10.27(18)*	Supplementary Employment Agreement between SCM Microsystems GmbH and Stephan Rohaly dated December 12, 2006.
10.28(19)*	Resignation and Severance Agreement between Robert Schneider and SCM dated June 18, 2007.
10.29(19)*	Consulting Agreement between Robert Schneider and SCM dated June 18, 2007.
10.30(20)*	Employment Agreement between Felix Marx and SCM dated July 31, 2007.
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 Registration Statement on Form S-8 (See SEC File No. 333-51792).

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(3) Filed previously as an exhibit to SCM s Annual Report on Form 10-K for the year ended December 31, 2000 (See SEC File No. 000-22689).

(4) Filed previously as an exhibit to SCM s Annual Report on Form 10-K for the year ended December 31, 2001 (See SEC File No. 000-22689).

(5) 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).

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

(7) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003

(see SEC File No. 000-29440).

(8) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (see SEC File No. 000-29440).

(9) Filed previously as exhibit 99.1 to SCM s Current Report on Form 8-K, dated July 28, 2003 (see SEC File No. 000-29440).

(10) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003 (see SEC File No. 000-29440).

(11) Filed previously as an exhibit to SCM s Registration Statement on Form S-8 (See SEC File No. 333-73061).

(12) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended March 31, 2004 (see SEC File No. 000-29440).

(13) Filed previously in the description of the Executive Compensation Arrangement set forth in SCM s Current Report on Form 8-K, dated September 21, 2004 (see SEC File No. 000-29440).

(14) Filed previously as an exhibit to SCM s Annual Report on Form 10-K for the year ended December 31, 2004 (See SEC File No. 000-29440).

(15) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (see SEC File No. 000-29440).

(16) Filed previously as an exhibit to SCM s Annual Report on Form 10-K for the year ended December 31, 2006 (See SEC File No. 000-29440).

(17) Filed previously as an exhibit to SCM s Quarterly Report on Form

10-Q for the quarter ended June 30, 2006 (see SEC File No. 000-29440).

(18) Filed previously as an exhibit to SCM s Current Report on Form 8-K, dated December 18, 2006 (see SEC File No. 000-29440).

(19) Filed previously as an exhibit to SCM s Current Report on Form 8-K, dated June 19, 2007 (see SEC File No. 000-29440).

(20) Filed previously as an exhibit to SCM s Current Report on Form 8-K, dated August 1, 2007 (see SEC File No. 000-29440).

* Denotes management compensatory arrangement.