SCM MICROSYSTEMS INC
Form 10-K
March 08, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2009

OR

¨ 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)**
1900-B Carnegie Avenue, Santa Ana, California	**92705**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s telephone number, including area code:

(949) 250-8888

Securities Registered Pursuant to Section 12(b) of the Act:

None

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock, $0.001 par value, and associated Preferred Share Purchase Rights

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicated by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ

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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer ¨ (do not check if smaller reporting company)	Smaller Reporting Company þ

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

Based on the closing sale price of the Registrant s Common Stock on the NASDAQ National Market System on June 30, 2009, the last business day of the Registrant s most recently completed second fiscal quarter, the aggregate market value of Common Stock held by non-affiliates of the Registrant was $44,177,232.

At March 5, 2010, the registrant had outstanding 39,160,319 shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Designated portions of the Company s Proxy Statement and Notice of Annual Meeting to be filed within 120 days after the Registrant s fiscal year end of December 31, 2009 are incorporated by reference into Part II, Item 5 and Part III of this Report.

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SCM Microsystems, Inc.

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For the Fiscal Year Ended December 31, 2009

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PART I

This Annual Report on Form 10-K, including the documents incorporated by reference in this Annual Report, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). For example, statements, other than statements of historical facts regarding our strategy, future operations and growth, 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 believe, could, should, would, may, anticipate, intend, plan, estimate, expect, project or the negative of these terms or othe Although we believe that our expectations reflected in or suggested by the forward-looking statements that we make in this Annual Report on Form 10-K 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 Annual Report on Form 10-K. 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 factors that could cause our actual results to differ materially from our expectations in the Customers, Research and Development, Competition, Proprietary Information and Technology and Ri Factors sections and elsewhere in this Annual Report on Form 10-K. These cautionary statements qualify all of the forward-looking statements included in this Annual Report on Form 10-K that are attributable to us or persons acting on our behalf.

ITEM 1. *BUSINESS*

Overview of the Company

SCM Microsystems, Inc. (SCM, the Company, we and us) is an international technology group focused on building the world s signature company in secure identification-based technologies. Through our group of recognized brands, we provide leading-edge products and solutions in the areas of physical and logical access control, identity management and radio frequency identification (RFID) systems to governments, commercial and industrial enterprises and consumers. Our growth model is based on a combination of disciplined acquisitive expansion and strong technology-driven organic growth from the companies within the group.

At the beginning of 2010, as more fully discussed in the Recent Developments in our Business section below, we acquired Bluehill ID AG (Bluehill ID), which focuses on technologies and investments within the high-growth security and identity management markets. As a result of this business combination, we have put in place a new organizational structure, enhanced and broadened our management team, adopted a new name and are now doing business as Identive Group. We intend to seek stockholder approval to amend our certificate of incorporation and officially change the name of the Company at our 2010 annual meeting. Following the acquisition of Bluehill we also changed our stock trading symbols to reflect our new name. Our common stock is now listed on the NASDAQ Stock Market in the U.S. under the symbol INVE and the regulated market (Prime Standard) of the Frankfurt Stock Exchange in Germany under the symbol INV.

Our goal is to build a lasting business of scale and technology to both enable and capitalize on the growth of the security and RFID industries. We employ a buy, build and grow strategy worldwide to build a leading identification and identity management company through a combination of technology driven organic growth and disciplined acquisitions. In particular, we pursue investments and acquisitions that drive consolidation in the rapidly growing, yet highly fragmented markets for identification-based technologies. We are comprised of a group of companies with deep industry expertise and well-known global brands in their individual markets. At the corporate level, we provide strategic guidance, operational support and market expertise to facilitate sharing of technology and resources among the companies to help our individual business units expand and compete more effectively in the global marketplace.

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Following our acquisition of Bluehill ID in January 2010, we now operate in two business segments, Identity Management Solutions & Services and Identification Products & Components. Each business segment is comprised of two or more companies within the group that focus on specific markets and technologies.

Companies in our Identity Management Solutions & Services (ID Management) business provide solutions and services that enable the secure management of credentials in diverse markets. These credentials are used for the identification of people and the granting of rights and privileges based on defined security policies. Companies in our ID Management business specialize in the design and manufacturing of highly secured and integrated systems that can enhance security and better meet compliance and regulatory requirements while providing users the benefits and convenience of simple and secure solutions. ID Management customers operate in government, commercial and enterprise markets and can be found in multiple vertical market segments including healthcare, finance, industrial, retail and critical infrastructure. Companies in our ID Management business include Hirsch Electronics and Multicard.

Companies in our Identification Products & Components (ID Products) business design and manufacture both standard and highly specialized products and components that help identify people, animals and objects in a multitude of applications and markets. Products and components in our ID Products business include semiconductors, cards, tags, inlays, readers and terminals that are used by original equipment manufacturers and system integrators to deliver identity based systems and solutions. These products are used for applications such as eHealth, eGovernment, mobile banking, loyalty schemes, transportation and event ticketing, corporate identification, logical access, physical access and passport control in the government, enterprise and financial markets. Within this business we also offer commercial digital media readers that are used in digital kiosks to transfer digital content to and from various flash media. Companies in our ID Products business include SCM Microsystems, TagStar Systems, Arygon Technologies, ACiG Technology and Syscan ID.

Each of our group companies generally conducts its own sales and marketing activities in the market segments in which they compete. In some cases, the companies utilize a direct sales and marketing organization; in others, this is supplemented by a dealer/systems integrator distribution channel, value added resellers, resellers and Internet sales. Companies in our ID Products business primarily sell to original equipment manufacturers (OEMs) that typically either bundle our products with their own solutions, or repackage our products for resale to their customers. Our OEM customers typically sell our ID Products solutions to government contractors, systems integrators, large enterprises and computer manufacturers, as well as to banks and other financial institutions. Additionally, we sell our CHIPDRIVE-branded productivity solutions through resellers and the Internet and we sell our digital media readers primarily to major brand computer and photo processing equipment manufacturers. Each of the companies within our ID Management business sells both directly and indirectly through a variety of channels. For example, Hirsch sells primarily through a dealer/systems integrator distribution channel and in some cases directly to government contractors. Multicard sells cards and card services directly to customers that employ them for corporate and government IDs, loyalty programs, fuel cards, access cards, and sport stadium tickets and purchases.

Our headquarters are co-located with our Hirsch business headquarters in Santa Ana, California and our European operational headquarters are in Ismaning, Germany. We maintain facilities in Chennai, India for research and development and in Australia, Brazil, Canada, Europe, Hong Kong, Japan and the U.S. for individual business operations and sales. The Company was founded in 1990 in Munich, Germany and incorporated in 1996 under the laws of the state of Delaware.

Recent Developments in our Business

On January 4, 2010, we acquired Bluehill ID, a Swiss industrial holding group focused on investments in the RFID/identification and security industries, pursuant to the Business Combination Agreement dated as of September 20, 2009, as amended, under which we made an offer to the Bluehill ID shareholders to acquire all of the Bluehill ID shares and issued 0.52 new shares of SCM common stock for every one share of Bluehill ID tendered. Approximately 29,422,714, or 92% of Bluehill ID shares outstanding were tendered in the offer and exchanged for a total of approximately 15,299,797 new shares of SCM common stock. The issuance of the shares of SCM common stock to the former shareholders of Bluehill ID was approved by our stockholders at a special meeting held on December 18, 2009. We will begin reporting consolidated results including Bluehill ID beginning in the first quarter of 2010. We are now doing business as Identive Group and are seeking stockholder approval at our 2010 Annual Meeting of Stockholders to amend our certificate of incorporation to legally change the name of the Company to Identive Group, Inc.

On April 30, 2009, we acquired Hirsch Electronics Corporation, a privately-held California corporation that designs, engineers, manufactures and markets software, hardware and services in the security management system/physical access control market. The acquisition of Hirsch Electronics Corporation was accomplished through a two-step merger, in accordance with the Agreement and Plan of Merger entered into on December 10, 2008, pursuant to which Hirsch Electronics Corporation became Hirsch Electronics LLC, a Delaware limited liability company and a wholly-owned subsidiary of the Company (Hirsch). In exchange for all of the outstanding capital stock of Hirsch, we paid approximately $14.2 million in cash, issued approximately 9.4 million shares of our common stock, and issued warrants to purchase approximately 4.7 million shares of our common stock. The merger was approved by our stockholders at a special meeting held on April 16, 2009. The results for the acquired Hirsch business are included in the Company s consolidated statements of operations since the April 30, 2009 acquisition.

On October 1, 2008, we entered into a Stock Purchase Agreement with TranZfinity, Inc. (TranZfinity), pursuant to which the Company purchased 10 million shares of TranZfinity common stock, or 33.7% of TranZfinity s outstanding shares (16.67% on a fully diluted basis), for an aggregate purchase price of $2.5 million. The transaction closed on October 2, 2008. We also entered into a Stockholders Agreement with TranZfinity and certain other stockholders of TranZfinity, which sets forth certain rights and privileges of the Company and the other stockholders of TranZfinity, including rights and privileges with respect to the composition of TranZfinity s Board of Directors. During the fourth quarter of 2009, we determined that the value of our investment in TranZfinity was impaired and we recorded a charge for the impairment to write-off 100% of our investment and our proportionate losses realized by TranZfinity of $2.2 million.

Through 2009 and therefore prior to the January 4, 2010 business combination with Bluehill ID, we operated in two business segments, Security and Identity Solutions and Digital Media and Connectivity. Sales of our Security and Identity Solutions products accounted for approximately 92% of our total revenue in 2009, approximately 84% in 2008 and approximately 80% in 2007. Sales of our Digital Media and Connectivity products accounted for approximately 8% of our total revenue in 2009, approximately 16% in 2008 and approximately 20% in 2007. Additional information about our results for the last three years for these segments is provided in Item 7, Management s Discussion and Analysis of this Annual Report on Form 10-K. Following our business combination with Bluehill ID in January 2010, our business profile has changed significantly. Going forward we will report our results using different segments that reflect our current organizational structure, business segments and focus, as described above. These new segments are not comparable with the business segments we formerly reported.

Companies within the Group

Currently, we have the following businesses and brands in our group of companies:

ACiG Technology. ACiG Technology is an independent supplier and value added distributor of RFID and smart card integrated circuits, inlays, reader modules and other components. In parallel, through ACiG Brazil, ACiG is active in wireless/telecommunication, semiconductors and opto-electronics distribution. ACiG also is a primary sourcing partner for RFID components for the rest of the companies within the group. ACiG leverages comprehensive market and technology know-how, expertise in virtual manufacturing and a direct business partnership with NXP, the leading semiconductor manufacturer in RFID and NFC (Near Field Communication). ACiG has operations in Europe (Germany), the U.S. and in Brazil. ACiG Technology was one of the Bluehill ID group companies acquired in the transaction with Bluehill ID. (www.acig-ag.de)

Arygon Technologies. Arygon is an early entrant and innovator in NFC/MIFARE RFID reader technology and related project services. The company manufactures advanced RFID reader modules for physical and logical access, transit and event ticketing, payment, government ID, industrial, medical and NFC applications. Arygon also supplies high-quality RFID cards, key fobs, wristbands, custom tags and NFC starter kits. Arygon was one of the Bluehill ID group companies acquired in the transaction with Bluehill ID. (www.arygon.de)

Hirsch Electronics. Hirsch designs, manufactures and sells security and identity management systems that integrate access control, video surveillance, intrusion detection, building management and other network-based systems using a wide range of credentials, including digital certificates, smart cards, RFID cards, and biometrics. Hirsch is the preferred access control vendor to some of the most recognized and demanding, security-conscious customers in the world. Hirsch is based in Santa Ana, California. (www.hirschelectronics.com)

Multicard. Multicard is a worldwide supplier of multi-functional smart card solutions for secure identification programs with in-house capabilities for credential issuance, personalization and fulfillment services for the consumer, government and corporate customers. Multicard offers ID systems management and engineering services as well as full implementation and program management. Multicard is also a provider of online enrollment services and portable biometric data capture equipment for enrollment of ePassport and other government ID and corporate ID applications. Multicard has locations in Switzerland, Germany, the Netherlands and Australia, and serves various different customer groups ranging from governments and municipalities, to commercial and industrial companies and non-governmental organizations. Multicard was one of the Bluehill ID group companies acquired in the transaction with Bluehill ID. (www.multicard.com)

SCM Microsystems. SCM Microsystems is a provider of solutions for secure access, secure identity and secure exchange. The company designs and manufactures a broad range of contact, contactless and mobile smart card reader and terminal technology, digital identity and transaction platforms that are utilized around the world to enable security and identification applications, transaction systems, eHealth- and eGovernment programs and physical access systems. The company also offers a range of smart card-based security, productivity and time recording solutions for small and medium-size businesses under its retail CHIPDRIVE® brand. Additionally, SCM provides commercial digital media readers to the worldwide photo kiosk market. SCM serves its global customer base with headquarters in Germany and sales offices in the U.S, Tokyo and Hong Kong. (www.scmmicro.com)

Syscan ID. Syscan ID (formerly Syscan International) is a producer of RFID ISO wand readers, also known as electronic id readers (EID) for livestock. The company is centered on animal ID, traceability, country of origin labeling (COOL) and age verification, as well as in industrial applications where a rugged RFID handheld reader is needed. Syscan ID also develops and customizes RFID readers and printer kits, offering complete mobile identification tools in the agriculture and industrial sectors. Markets are keyed to wherever livestock traceability and industrial tracking management is needed, which includes Europe, North America, South America and Australia. Syscan ID was one of the Bluehill ID group companies acquired in the transaction with Bluehill ID. (www.syscan.com)

TagStar Systems. TagStar Systems is an RFID transponder manufacturer based in Germany with significant know-how in the design and manufacture of RFID inlays. RFID inlays are purchased by specialist companies for conversion into event or venue cards or tickets, such as ski tickets, football games or concerts, and for transport tickets and passes. TagStar Systems particular skill is to cost-effectively combine and connect integrated circuit chips from NXP, Infineon, and others, with antennas

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into an inlay that can withstand the physical and environmental stresses in the applications that their products are used. TagStar Systems was one of the Bluehill ID group companies acquired in the transaction with Bluehill ID. (www.tagstar-systems.de)

Need for Identification Systems

Individuals, businesses, governments and educational institutions increasingly rely upon computer networks, the Internet and intranets for information, services and entertainment. The proliferation of and reliance upon electronic data and electronic transactions has created a greater need to protect the integrity of digital data, as well as to control access to electronic networks and the devices that connect to them. Organizations such as corporations, government agencies, financial institutions, banks and others are adopting higher security identification systems to protect and manage the use of their facilities, networks and digital data in addition to managing the access rights of customers, citizens and employees. Examples of such identification systems include large-scale, government-led national and military identification programs utilizing electronic ID cards, bank cards, and physical access control systems used to protect facilities, among others. Increasingly, such identification systems employ contactless technology for reasons of security, convenience and cost.

Radio Frequency Identification (RFID) is a core technology that allows for identification and communication between two or more devices via radio frequency. It is rapidly emerging as the replacement for traditional identification devices, such as those utilizing simple barcodes to more sophisticated smart cards that require a direct contact interface. RFID is used in identification systems to identify and/or track objects on a local or global scale and is employed in a wide variety of applications, including ePassports, touch-and-go credit cards, ski and stadium passes, transportation tickets and personal and corporate identification cards.

Market for RFID-based Information Systems

The market for RFID technology has grown rapidly in recent years, from $4.9 billion in 2007 to $5.3 billion in 2008 and was estimated to be $5.5 billion by the end of 2009 (IDTechEx & ABI Research). For calendar year 2010 it is expected to grow by 16% and reach $6.1 billion according to ABI Research in their RFID Annual Market Overview. ABI Research s longer term projections for the overall RFID market also look healthy with an estimated 11% CAGR through 2014, when the market is expected to approach $9.2 billion. A primary driver of RFID growth is the increase in programs being implemented by governments and companies to identify and control individuals and access. Government mandates are a significant driver of market growth, as they create the demand for effective and efficient ways to identify and track people, animals and goods. As organizations augment or expand their existing security systems, RFID technology also provides a convenient and cost effective way to extend authentication of users to multiple points in the systems, for example entry doors and PCs. Additionally, consumer-oriented entities are turning to RFID to facilitate and speed up payment, client identification and admission to a variety of events.

Among the markets in which high-value RFID identification systems can be employed, access control, electronic payment, mass transit, and government ID are expected to experience the most significant growth in the medium and long term.

Access Control. RFID technology is now standard in most automobiles, routinely used to unlock and secure the vehicle. It is also commonly applied to regulate access to events and buildings through corporate or employee identification cards or key fobs. In addition to physical access control (e.g., to work sites or buildings), logical access control (e.g., to PCs or IT networks) is growing in importance as companies and governments seek to control access to their electronic files and computer systems. In more sophisticated applications, physical and logical access control is being combined into a single system. For example, in the U.S., Homeland Security Presidential Directive (HSPD)-12 and Federal Information Processing Standards (FIPS) 201 mandate that personal identification verification cards utilizing secure contactless interface technologies be issued to all personnel, across federal agencies, both to provide secure authentication of employees and to provide secure access to both facilities and computer networks. Identification cards issued under other U.S. government programs are also required to comply with FIPS 201, including Transportation Worker Identification Credential (TWIC) cards, First Responder Authentication Credential (FRAC) cards and Aviation Credential Interoperable Solution (ACIS) cards.

Payment. As RFID technology has become more standardized and found wider consumer acceptance, banks and other financial institutions have begun to use it in advanced applications. Compared to many other forms of existing technology, RFID offers higher data transmission capacity and speed, improved convenience and additional security features that make it ideal for use in sensitive applications, such as contactless payment systems. Various financial institutions have begun issuing RFID-based contactless payment cards which will eventually replace cards containing only the conventional magnetic stripe. For example, MasterCard (Paypass), Visa (Contactless Visa) and others already have contactless payment systems in place.

Contactless payment cards offer improved security compared to conventional magnetic stripe-type bank, credit and debit cards, as the microchips on the cards include encryption algorithms and are, therefore, more difficult to copy or forge. Contactless payment cards also do not have to leave their owner s possession, which reduces the likelihood that illicit imprints of the cards will be made and makes such cards more convenient to use. Finally, as a result of a legal change in the U.S. that makes signatures unnecessary for purchases of less than $25, contactless card-based payment has caught on, since transactions using contactless payment cards are more quickly completed and therefore a distinct advantage.

Government ID (including ePassports). The security benefits of RFID technology are well-suited for use in electronic passports, national ID cards and drivers licenses. RFID-enabled passports (ePassports) contain an embedded integrated circuit chip that is used to store and transmit identifying data, including optional biometric features such as pictures, fingerprints or iris scan information. Because ePassports are very difficult to forge and can store and quickly transmit a substantial amount of biometric information, they make it more difficult for people to travel under assumed identities and facilitate the processing of passengers at ports of entry. In 2003, the International Civil Aviation Organization (ICAO), a specialized agency of the United Nations that defines standards for electronic travel documents, selected contactless chips utilizing RFID as the standard for electronic passport technology. Many countries are also specifying the use of this technology for citizen identification cards, healthcare cards and drivers licenses. National ID programs are in process in Argentina, Belgium, Brazil, China, Egypt, Germany, India, Netherlands, Peru, Poland, Saudi Arabia, Serbia, South Africa, South Korea, Spain, Turkey, Venezuela, and others.

Mass Transit. In many areas of the world, contactless cards used to pay fares and tolls in mass transit and highway systems have been the driving factor in consumer acceptance of contactless technology. Contactless cards have been introduced in many of the largest mass transit systems around the world, including the Sao Paolo transportation system, the Malaysian Road Toll System, the Singapore EZ Link, and the Oyster card in London. Such cards reduce traffic congestion, improve efficiency and reduce the need for people to handle cash, thereby improving security. Many passengers find the cards more convenient to use than traditional tickets. In addition, such cards can be combined with contactless payment functions (for use in restaurants and convenience stores, for example) or loyalty systems, which further increases passenger convenience. Mass transit cards have historically accounted for the largest share of the contactless card market and have constituted the most practical and visible demonstration of the technology s potential.

Convergence Trends

Within these markets, there are three important convergence trends that offer significant opportunity for companies that can address and leverage them with a combination of broad-based solutions and individual market expertise. These trends include i) the integration of physical and logical access systems, ii) the enhancement of smart cards with contactless technologies and iii) the marriage of identification technologies with mobile communication.

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The integration of physical and logical access systems is underway and well understood. The need to secure both physical facilities and computers and corporate networks also is now well recognized. Traditionally, organizations have had disparate systems and policies for physical (e.g., buildings) and logical (PCs or IT networks) security. This often caused gaps in security as breaches can occur due to the inability of the different systems to communicate. Increasingly, physical and logical access control systems are now being combined into a single system, which enables an organization to provide integrated, policy-based logical and physical access as well as network provisioning throughout a user s lifecycle. New security policies are therefore practical; for example, physical presence becomes a prerequisite for granting or denying network access and enables correlated activity reporting and responses. Organizations recognizing the benefits of combining physical and logical access systems are investing in the migration towards new integrated systems.

A second convergence trend takes advantage of the enhancement of smart cards with contactless technologies. With the mass deployment of electronic passport schemes on a global basis, contactless smart chip technology has proven its maturity and reliability when incorporated in secure documents. As a result, other sovereign documents such as national IDs, military and other government-issued IDs, driver s licenses, residence permits, weapon licenses and the like, are migrating to chip-based technology. The enhancement of chip based cards with contactless technology is also a key feature in payment systems. In the financial industry, major credit card companies in many parts of the world are embracing contactless smart card technology as a more secure way to safeguard electronic transactions and address the problems of fraud, identity theft and protection of privacy, while increasing ease of use for their customers.

Finally, the marriage of identification technologies with mobile communication is transforming the way that consumers use mobile phones and other handheld devices by enabling new applications for communication, social interaction, and electronic transactions. With smart device capabilities, mobile phones and other devices enable consumers to purchase goods and services electronically and conveniently, while ensuring security through individual authentication of the user. In effect, the mobile phone becomes an electronic wallet that can handle payment and other secure transactions. Integration of contactless payment technology into mobile phones is expected to further spur demand for contactless technology over the next several years. According to the research firm Gartner Group, the number of consumers using mobile payment services via mobile phones and other devices is expected to grow from 32.9 million users in 2008 to 103.9 million in 2011.

The Identification System Value Chain

To supply the various applications in the marketplace for RFID-based identification systems, a value chain has developed that comprises many steps and is fairly complex. As with other technology offerings in developing markets, many small players have emerged to supply the different components of a system. The majority of contactless identification systems consist of three components: 1) a transponder which acts as a data carrier and may be in the form of a smart card, tag, key fob or label, 2) a reader and 3) a software system.

Each of these components is critical to the overall identification system and together they can be applied in multiple and diverse ways to address a variety of applications, ranging from identity management and access control for programs such as transportation, event ticketing, national/citizen ID, enterprise/corporate ID and consumer ID, to secure the identification of people, animals, objects or their logistics. Typically, a supplier focuses on one or two of the areas that make up a contactless identification system:

Transponders

Silicon chip components and wafers. Silicon chip components and wafers are manufactured by multinational chip manufacturers. This segment of the industry is very capital intensive. The individual chips from each silicon wafer must be packaged into a module before they can be processed by an inlay manufacturer. Most of the chip manufacturers also provide these packaging services.

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Antennae. The next step is fabricating and attaching an antenna for the transponder device. This is a critical step in the process because both the materials and geometry utilized for the antenna design as well as the method by which the leads are attached to the chip greatly affect the performance of radio frequency communication, reliability of the final transponder, and cost of the device. A great variety of intellectual property exists in this area with patents and process knowledge. Companies owning this knowledge can have significant competitive advantages in product performance and costs. In most cases, the methodology is very different for low frequency versus high or ultra high frequency devices, raising barriers for a single organization to easily migrate from one to another.

Inlay of chip modules and antennae. The chip modules are processed by inlay manufacturers who bond the chip module and an antenna to a carrier material or substrate, such as plastic, that will form part of the finished product, whether it is an ID card, a key fob, a smart label, a contactless credit card or an ePassport. Each application places different demands on the chip and antenna embedding process, depending on the carrier material and the required durability and reliability of the finished product. The different processes used to produce antennas (embedding, etching or printing) and the various techniques utilized by inlay manufacturers to connect antennas to chips (such as wire bonding or flip-chip) have distinct advantages and disadvantages with regard to these criteria. Utilizing the proper process is crucial for many RFID applications, both economically and practically.

Card manufacturers. Card manufacturers purchase sheets of inlays. The sheets are cut and processed by the card manufacturers in a lamination and printing process to produce functional RFID cards. At this stage, for example, the cards may be printed with a bank s logo and other information, but the cards do not contain personal information concerning the end-user. Increasingly, card manufacturers are being asked to install software (consisting of an operating system and application software) on the chips embedded in their cards. Card manufacturers typically sell cards to system integrators and end customers (e.g., the owners of the access control or mass transit systems).

Secure printing houses. Governmental documents, corporate credentials, and credit cards, including ID cards, driver s licenses, credit/debit cards, loyalty cards with value, and passports are produced by secure printing houses. These secure printing houses can be private companies or governmental printers. To produce ePassports, for example, secure printing houses purchase high security inlays from inlay manufacturers and other special paper and packaging and incorporate them into the finished ePassports or chip cards. Secure printing houses sell the completed passports or other secure ID cards to system integrators and national governments, who provide them to their citizens and corporate customers.

System integrators. System integrators purchase printed and laminated cards from card manufacturers, printed and assembled ePassport booklets from secure printing houses and, in certain instances, white cards from inlay manufacturers. To produce white cards, an inlay manufacturer conducts the lamination process and supplies a system integrator with functional, but blank, white cards. The system integrator personalizes the cards and ePassports by putting software (an operating system and application software such as security algorithms or keys, memory initialization or formatting, or specific application data) and relevant data on the embedded chips. This final step in the transponder value chain is also called initialization. The initialization or personalization process may also involve printing the end-user s name and picture on the card or ePassport. The system integrator supplies the finished cards to the client (e.g., a company installing a new employee security system) or to the end-user directly (e.g., cards issued to customers of a credit card issuing bank).

Readers. RFID reader design and construction typically reflects the needs of an application in form, function, and aesthetics. Although varied in appearance from one application to another, the basic functions and components of an RFID reader are similar. The first elements are very similar to a transponder since they perform the same radio frequency communication data transfer functions: antenna and chip. The other elements include electronics, firmware, and packaging. These typically accommodate the requirements of the application, including multiple device read handling, read range, form factors, power requirements, and environmental ambient conditions.

ID System Software and Interfaces. Some of the software associated with identification (ID) systems resides on the reader and/or the transponder, depending on its level of intelligence. Other software is at the application level to manage the database of user data and provide the tools to issue and track the use and transactions of the card. This can be a significant area of added value by providing systems and application support. In simpler applications this can be only a basic read capability, data formatting, and interfacing to an upstream communication network. In more complex, multi-application uses, it could include multi-communication protocols, different levels of security, authentication, encryption, memory management, operating system environment support for specific application needs, as well as complex ID/key management methods, database management, archiving, transaction proofing processing, and reporting. Typically, ID system software is modular and can be utilized across multiple applications, for example student transport, cafeteria, library and payment.

Our Specific Opportunity

We believe that there is a significant opportunity to build a global, market-leading business that is capable of providing multiple areas of the RFID-based information system value chain and to address high-growth markets, including those experiencing technology convergence. We are actively pursuing a strategy of investing along the RFID-based information system value chain in order to acquire best practice companies of all production levels and combine their strategic and technical organizations, in order to create a market leading position in this segment of the information system space.

How We Address Opportunities in the Information System Value Chain

Through our current group of companies and execution of our acquisition strategy, we aim to provide offerings that are broadly applicable and also integrated along many stages of the RFID-based identification system value chain, enabling customers and partners to turn to a single source to meet many of their needs for identification-based products and services.

Our development center and group of companies currently address initial coverage of several important areas of the RFID-based identification systems value chain:

Segment of the Value Chain	**Our Coverage**
Silicon chip components and wafers	*ACiG Technology* has a direct business partnership with NXP, the leading semiconductor manufacturer in RFID and NFC.
Antennae	*TagStar* expertise in antenna design and material packaging in HF and UHF.
	Development Center in India expertise in antenna design in LF and HF for passports, readers, desktop applications.
Inlay production	*ACiG Technology* supplier and value added distributor of RFID and smart card ICs, inlays and other components. Sourcing partner for Bluehill ID providing other companies within the group with RFID components.
	TagStar know how in the design and manufacture of RFID inlays for cards used in ski applications, industrial and medical applications, event and transportation tickets and passes.
Readers	*SCM Microsystems* leading supplier of smart card readers and components for PCs, networks, physical facilities and authentication programs. Products include both contact and contactless smart card readers and terminals, USB tokens, ASICs and small office productivity packages based on smart cards, sold under SCM CHIPDRIVE brand.

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Segment of the Value Chain	Our Coverage
	ACiG Technology supplier and value added distributor of RFID reader modules.
	Arygon manufactures advanced RFID reader modules for physical and logical access, transit and event ticketing, payment, government ID, industrial, medical and NFC applications.
	Syscan ID producer and supplier of RFID mobile wand readers (electronic ID readers) for livestock and industrial applications.
Card Personalization /Secure Printing Houses	*Multicard* (Australia, Switzerland) suppliers of multi-functional smart card solutions for secure identification programs. In-house capabilities for credential issuance, personalization and fulfillment services for the consumer, government and corporate markets. Provider of online enrollment services and portable biometric data capture equipment for enrollment of ePassport and other government and corporate ID applications.
ID System Software and Interfaces	*Multicard* (Germany, Netherlands, Australia) worldwide supplier of multi-functional smart card solutions for identification programs and for payment, stadiums, and ticketing/voucher/loyalty systems. A supplier of hardware and software for ID/key management, database management, archiving, transaction processing, and reporting.
	Hirsch leading provider of security and identity management systems that integrate access control, video surveillance, intrusion detection, building management and other network-based systems using a wide range of credentials, including digital certificates, smart cards, RFID cards, and biometrics.

In addition to covering the key technologies in the identification systems value chain, we also address key vertical markets that require identification-based technologies. To address these markets, we have organized our group companies to focus on two main segments, ID Management and ID Products. Together, our ID Management and ID Products technologies and solutions place us in a unique position to address the requirements of these markets, including technology convergence trends.

Each of these trends has important implications in its respective markets, giving rise to competitive advantage for companies that not only can talk about the convergences but can also deliver them. Within our group of companies, we have North American leaders in physical and logical access systems in Hirsch and SCM Microsystems, respectively. We have a global leader in contact readers applied to PCs and networks in SCM Microsystems and a leader in smart card applications in Germany Multicard. Through Multicard we also provide mobile applications and services to governments and financial institutions to facilitate cashless payments. In short, the group provides identification and authentication solutions for applications ranging from security to asset tracking to transaction processing, for mobile and fixed installations, through multiple offerings and at different stages of the value chain.

Additionally, a primary component of our strategy is to increase our coverage of the RFID-based identification systems value chain through mergers and acquisitions and to gradually extend our products, solutions and services to address our target vertical markets.

Customers

Through 2009 and prior to our business combination with Bluehill ID, the majority of our customers were in market segments requiring a higher-than-average level of security effectiveness, including government, large enterprises, public utilities and other critical infrastructure, data centers, healthcare, education, communications, finance, transportation and manufacturing. Bluehill ID s customer base is similar and we expect that security conscious customers will continue to account for the majority of our sales in 2010 and beyond. Prior to our merger with Hirsch, sales to a relatively small number of customers historically accounted for a significant percentage of the Company s total sales. Sales to our top ten customers accounted for approximately 42% of total revenue in 2009 (which includes sales made by the Hirsch business in the last eight months of 2009), approximately 58% of total revenue in 2008 and 61% of total revenue in 2007. In 2009, no customer accounted for more than 10% of the Company s total revenue. In 2008, Tx Systems, Inc and Flextronics America, LLC (formerly Solectron) each accounted for more than 10% of the Company s total revenue. In 2007, Envoy Data Corporation accounted for more than 10% of the Company s total revenue. In our Hirsch business, the top ten customers for the fiscal year ended November 30, 2008 accounted for approximately 30% of Hirsch s revenue. In the future, we expect that the greater diversity of our customer base following our business combination with Bluehill ID will substantially offset our dependence on a limited number of customers in our SCM Microsystems business areas. However, the loss or reduction of orders from a significant customer, including losses or reductions due to manufacturing, reliability or other difficulties associated with our products, changes in customer buying patterns, or market, economic or competitive conditions in the digital information security business, could still impact our business and operating results.

Sales and Marketing

For the majority of our sales, we utilize a multi-tiered sales organization consisting of OEMs, distributors, dealers/system integrators, value added resellers, resellers and Internet sales. Across all our businesses, we sell both directly and indirectly and our sales staff solicits prospective channel partners and customers, provides technical advice and support with respect to our products and works closely with customers, distributors and OEMs. In a number of our businesses we utilize authorized dealers or resellers who in turn resell and install our products, and who are trained by the individual businesses. In support of our sales efforts, we participate in trade shows and conduct sales training courses, targeted marketing programs and advertising, and ongoing customer and third-party communications programs. At December 31, 2009, we had 86 full-time employees engaged in sales and marketing activities.

Backlog

We typically do not 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. Sales are made primarily pursuant to purchase orders for current delivery or agreements covering purchases over a period of time. Our customer contracts generally do not require fixed long-term purchase commitments. In view of our order and shipment patterns, and because of the possibility of customer changes in delivery schedules or cancellation of orders, we do not believe that such agreements provide meaningful backlog figures or are necessarily indicative of actual sales for any succeeding period.

Research and Development

We have made substantial investments in research and development (R&D), particularly in the areas of smart card-based physical and network access devices, physical access controllers, readers and security management software, and digital connectivity and interface devices. Bluehill ID also has made significant R&D investments in the areas of inlays, readers, and software systems. We will continue to invest in R&D that advances key areas of our business. To ensure the effective use of R&D resources within each company and to facilitate sharing of technologies and expertise between companies, we have appointed an Executive Vice President of Technology and Product Management. Within each company and as needed between companies, our engineering design teams work cross-functionally with marketing managers, applications engineers and customers to develop products and product enhancements to meet customer and market requirements. We also strive to develop and maintain close relationships with key suppliers of components and technologies in order to be able to quickly introduce new products that incorporate the latest technological advances. Our future success will depend upon our ability to develop and to introduce new products that keep pace with technological developments and emerging industry standards while addressing the increasingly sophisticated needs of our customers.

We focus the bulk of our R&D activities on the development of products for new and emerging market opportunities. Prior to our business combination with Bluehill ID, R&D expenses were approximately $5.1 million for the year ended December 31, 2009, $3.9 million for the year ended December 31, 2008 and $3.1 million for the year ended December 31, 2007. As of December 31, 2009, we had 78 full-time employees engaged in R&D activities, including software and hardware engineering, testing and quality assurance and technical documentation. The majority of our R&D activities for smart card reader, ePassport reader and digital media reader products occurs in India, the majority of R&D activities for our Hirsch products occurs in California and the majority of R&D activities for inlays occur in Sauerlach, Germany and the majority of R&D activities for software systems occurs in Villingen, Germany and Rotterdam, the Netherlands. As a result of the acquisition of Bluehill ID, we now have two development centers located in Chennai, India. As announced and as filed with the SEC on a current report on Form 8-K on February 3, 2010, we intend to combine and streamline these two operations in order to lower operating costs.

Manufacturing and Sources of Supply

For the most part, we utilize the services of contract manufacturers in various countries around the world to manufacture our products and components. In general, each company within the group manages its own manufacturing activities. Our Hirsch products are manufactured primarily in California, using locally sourced components Our SCM smart card reader and digital media reader products and components are manufactured in Singapore and China and SCM is certified to the ISO 9001:2000 quality manufacturing standard. Products and components for our Arygon smart card readers and ePassport readers are manufactured in Germany and India. Inlay products are manufactured and assembled by TagStar s internal manufacturing organization in Sauerlach, Germany, using components sourced both locally and in Asia. As of December 31, 2009 and prior to our business combination with Bluehill ID, we had 29 full-time employees engaged in manufacturing and logistics activities, focused on coordinating product management and supply chain activities between the Company and our contract manufacturers.

Each of our companies has a formal quality control program to satisfy customer requirements for high quality and reliable products. To ensure that products manufactured by third parties are consistent with internal standards, quality control programs include management of all key aspects of the production process, including establishing product specifications, selecting the components to be used to produce products, selecting the suppliers of these components and negotiating the prices for certain of these components. In addition, our companies may work with suppliers to improve process control and product design.

We believe that our success will depend in large part on our ability to provide quality products and services while ensuring the highest level of security for our products during the manufacturing process. In the event any of our contract manufacturers are unable or unwilling to continue to manufacture our products, we may have to rely on other current manufacturing sources or identify and qualify new contract manufacturers. Any significant delay in our ability to obtain adequate supplies of our products from current or alternative sources would harm our business and operating results.

On an ongoing basis, we analyze the need to add alternative sources for both our products and components. Even so, we rely upon a limited number of suppliers for some key components of our products. For example, we currently utilize the foundry services of external suppliers to produce ASICs for our SCM smart cards readers, we utilize external suppliers to produce chips and obtain antenna components from third-party suppliers for our inlays and smart card readers. Wherever possible, we have added additional sources of supply for components. However, a risk remains that we may be adversely impacted by an inadequate supply of components, price increases, late deliveries or poor component quality.

In our Hirsch business, most component parts used in Hirsch products are standard, off-the-shelf items, which are, or can be, purchased from two or more sources. Because Hirsch has been building its core products for several years, there are a few parts that have reached end-of-life status. Hirsch has been able to continue to source those parts, but continued availability and pricing of older components in the future is not guaranteed. To mitigate this risk, Hirsch is designing new products that also will use standard off-the-shelf parts that are all expected to be in production for a greater number of years in the future. A significant portion of Hirsch s revenue is derived from the resale of cards and card readers from HID. If that supply were to be disrupted, Hirsch would be adversely affected. Hirsch resells Dell computers and servers, and disruption of that supply would adversely affect it. Hirsch out-sources the stuffing of printed circuit boards to local manufacturers. The bulk of that out-sourcing is to a single company, and disruptions within that company would adversely affect Hirsch. There are numerous similar manufacturing companies within southern California, so any disruption could likely be mitigated within a reasonable time.

As a result of our business combination with Bluehill ID, we expect to be able to expand the application of the existing global sourcing strategy that has been implemented by ACiG Technology for the Bluehill ID companies to serve all the companies within the group. We believe our global sourcing strategy will enable us to achieve economies of scale and uniform quality standards for our products, and to support gross margins.

Competition

The market for identification-based technologies is competitive and characterized by rapidly changing technology, as well as fragmentation of solutions providers. We believe that competition in this market is likely to intensify as a result of anticipated increased demand for RFID and other security solutions. We currently experience competition from two major sources: industry providers and investment companies.

Industry Providers. Companies within the group face competition from industry providers across the range of our products, solutions and value chain. Smart card readers, ASICs and universal smart card reader interfaces for PC and network access are available from a variety of sources, primarily originating in Asia. Enterprise-class and medium level physical access control systems are available both domestically and abroad from numerous suppliers in many countries. Most are single country or single continent providers with only a few being truly international in scope. This is primarily attributable to specific language requirements, local security processes and procedures, and different channels to market. In our RFID inlays and card services business, competitors are from a smaller number of organizations, owning to the specialized processes and capital equipment required.

Investment Companies. We also consider all industrial and investment companies pursuing consolidation strategies in the RFID sector with a similar business model to ours to be competitors. A large number of companies are active in the classical investment business with emphasis on the acquisition, holding and sale of companies. Additionally, private investors, venture capital companies, private equity firms, hedge funds and strategic investors can represent competition to us on specific, single investments. Additionally, the identification market and in particular RFID continue to attract significant investments from venture capital firms. A number of private equity companies have also made investments in RFID, including Invision (Switzerland), FSI and Iris (France), DEWB, Cornerstone Capital and Ventizz (Germany), Pod Holding (Sweden), as well as several other U.S.-based private equity houses.

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. We may in the future face competition from these and other parties that develop security and RFID products based upon approaches similar to or

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different from those employed by us. In addition, the market for security and RFID products may ultimately be dominated by approaches other than the approach marketed by us. We believe that the principal competitive factors affecting the market for our products include:

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

While we believe that we compete favorably within our market environment, we may not be able to continue to successfully compete due to a variety of factors. Competitive pressures we face could materially and adversely affect our business and operating results.

Proprietary Technology and Intellectual Property

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. Additionally, our Hirsch business utilizes Intellectual Property Infringement Abatement Insurance to partially mitigate the risk of infringement of its primary patent. Although we often seek to protect our proprietary technology through patents, it is possible that no new patents will be issued, that our proprietary products or technologies are not patentable, and that any issued patent will fail to provide us with any competitive advantages.

There has been a great deal of litigation in the technology industry regarding intellectual property rights and from time to time we may be required to use litigation to protect our proprietary technology. This may result in our incurring substantial costs and there is no assurance that we would be successful in any such litigation. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to use our proprietary information and software without authorization. In addition, the laws of some foreign countries do not protect proprietary and intellectual property rights to the same extent as do the laws of the U.S. Because many of our products are sold and a substantial portion of our business is conducted outside the U.S., our exposure to intellectual property risks may be higher. Our means of protecting our proprietary and intellectual property rights may not be adequate. There is a risk that our competitors will independently develop similar technology, duplicate our products or design around our 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.

In addition, we have from time to time received claims that we are infringing upon third parties intellectual property rights. Future disputes with third parties may arise and these disputes may not be resolved on terms acceptable to us. As the number of products and competitors in our target markets grow, the likelihood of infringement claims also increases. Any claims or litigation may be time-consuming and costly, divert management resources, cause product shipment delays, or require us to redesign our products, accept product returns or to write off inventory. Any of these events could have a material adverse effect on our business and operating results.

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We own approximately 40 patent families (designs, patents, utility models and exclusive licenses) comprising a total of 80 individual or regional filings, covering products, mechanical designs and ideas for our various businesses. None of our patents are material to our business. Additionally, we leverage our own ASIC designs for smart card interface in our some of our reader devices.

Employees

As of December 31, 2009, and prior to our business combination with Bluehill ID, we had 225 full-time employees, of which 78 were engaged in engineering, research and development; 86 were engaged in sales and marketing; 29 were engaged in manufacturing and logistics; and 32 were engaged in general management and administration. We are not subject to any collective bargaining agreements and, to our knowledge, none of our employees are currently represented by a labor union. To date, we have experienced no work stoppages and believe that our employee relations are generally good.

Foreign Operations; Properties

We operate globally, with corporate headquarters in Santa Ana, California and European operational headquarters in Ismaning, Germany. We lease research and development facilities in Chennai, India. Our individual companies also maintain leased facilities in Australia, Brazil, Canada, Germany, Hong Kong, Italy, Japan, the Netherlands, Switzerland and the U.S. We consider these properties as adequate for our business needs. During the fourth quarter of 2009, we sold a facility in India for cash of $1.8 million and recognized a pre-tax gain of $1.2 million on the transaction.

Legal Proceedings

From time to time, we could become 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, our management expects that any such liabilities, to the extent not provided for by insurance or otherwise, would not have a material adverse effect on our financial condition, results of operations or cash flows.

We are not currently nor in the past twelve months have we been a party to any pending legal, governmental or arbitration proceeding, nor is, or was in the past twelve months our property the subject of any pending legal, governmental or arbitration proceeding, that is not in the ordinary course of business or otherwise material to the financial condition of our business nor are we aware that such proceedings are threatened.

Availability of SEC Filings

We make available through our website our Annual Reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports free of charge as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission (SEC). Our Internet address is www.identive-group.com. The content on our website is not, nor should be deemed to be, incorporated by reference into this Annual Report on Form 10-K. Additionally, documents filed by us with the SEC may be read and copied at the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. Our filings with the SEC are also available to the public through the SEC s website at www.sec.gov.

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ITEM 1A. *RISK FACTORS*

Our business and results of operations are subject to numerous risks, uncertainties and other factors that you should be aware of, some of which are described below. The risks, uncertainties and other factors described in the following risk factors 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.

Risks of Market Dynamics

Disruption in the global financial markets may adversely impact the availability and cost of credit.

We may seek or need to raise additional funds. Our ability to obtain financing for general corporate and commercial purposes or acquisitions depends on our operating and financial performance, and is also subject to prevailing economic conditions and to financial, business and other factors beyond our control. The global credit markets and the financial services industry have been experiencing a period of unprecedented turmoil characterized by the bankruptcy, failure or sale of various financial institutions. An unprecedented level of intervention from the U.S. and other governments has been seen. As a result of such disruption, our ability to raise capital may be severely restricted and the cost of raising capital through such markets or privately may increase significantly at a time when we would like, or need, to do so. Either of these events could have an impact on our flexibility to fund our business operations, make capital expenditures, pursue additional expansion or acquisition opportunities, or make another discretionary use of cash and could adversely impact our financial results. In any case, there can be no assurance that such funds, if available at all, can be obtained on terms reasonable to us.

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

We are exposed to credit risk in our accounts receivable, and this risk is heightened in times of economic weakness. We distribute our products both through third-party resellers and directly to certain customers and a 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.

Continuing disruption in the global financial markets may adversely impact customers and customer spending patterns.

Continuing disruption in the global financial markets as a result of the ongoing global financial uncertainty may cause consumers, businesses and governments to defer purchases in response to tighter credit, decreased cash availability and declining consumer confidence. Accordingly, demand for our products could decrease and differ materially from their current expectations. For example, as part of our focus on the commercial and industrial markets, a portion of our business is subject to conditions in the commercial construction and renovation sector. A decline in new commercial construction or a significant decline in renovation projects due to the global economic downturn could have a material adverse effect on the results of operations of this business. Further, some of our customers may require substantial financing in order to fund their operations and make purchases from us. The inability of these customers to obtain sufficient credit to finance purchases of our products and meet their payment obligations to us, or possible insolvencies of our customers, could result in decreased customer demand, an impaired ability for us to collect on outstanding accounts receivable, significant delays in accounts receivable payments, and significant write-offs of accounts receivable, each of which could adversely impact our financial results.

Disruption in the global financial markets may adversely impact our suppliers.

Our ability to meet customers demands depends, in part, on our ability to obtain timely and adequate delivery of quality materials, parts and components or products from our suppliers. Certain of our components are available only from a single source or limited sources. If certain key suppliers were to become capacity constrained or insolvent as a result of economic weakness either regionally or globally, it could result in a reduction or interruption in supplies or a significant increase in the price of supplies, each of which would adversely impact our financial results. In addition, credit constraints at key suppliers could result in accelerated payment of accounts payable by us, impacting our cash flow.

Our markets are highly competitive.

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

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

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

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

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

Strategic Risks

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. Changes in market requirements could render our existing solutions obsolete or could require us to expend more on research and development efforts. For example, a significant portion of our revenues results from the sale of access control panels that include certain design elements that are more than a decade old. These controllers are typically used in a network architecture that may become outdated or obsolete. If a product is deemed to be obsolete or unmarketable, then we might have to reduce revenue expectations or write down inventories for that product. We may also lose market share.

Our future success will depend upon our ability to enhance our current products and to develop and introduce new products with clearly differentiated benefits that address the increasingly sophisticated needs of our customers and that keep pace with technological developments, new competitive product offerings and emerging industry standards. 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. Our failure to develop, manufacture, launch and sell next-generation security products and architectures for both physical and logical security could significantly affect our financial performance. 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.

Sales of our products depend on the development of emerging applications in our target markets and on diversifying and expanding our customer base in new markets and geographic regions, and with new products.

We sell our products primarily to address emerging applications that have not yet reached a stage of mass adoption or deployment. For example, we sell our smart card readers for use in various smart card-based security programs in Europe, such as electronic driver s licenses, national IDs and e-passports, which are applications that are not yet widely implemented. In our Bluehill ID business, our solutions are used in various smart card-based identification programs in Europe, such as transit, payments, ticketing, national and regional IDs and stadiums, which are applications that are not yet widely implemented.

We are also focused on expanding sales of professional services, identity management and RFID products and solutions. The market for some of these solutions is at an early stage of development compared to the market for traditional access control. Additionally, we have a strategy of expanding sales of existing product lines into new geographic markets and diversifying and expanding our customer base, and have recently added sales resources to target authentication programs in the government and enterprise sectors in Asia, and have begun to target the photo kiosk markets in Europe and Asia.

Because the markets for our products are still emerging, demand for our products is subject to variability from period to period. There is no assurance that demand will become more predictable as additional smart card programs demonstrate success. If demand for products to enable smart card-based security applications does not develop further and grow sufficiently, our revenue and gross profit margins could decline or fail to grow. We cannot predict the future growth rate, if any, or size or composition of the market for any of our products. Our target markets have not consistently grown or developed as quickly as we have 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, for example the economic uncertainty;
- our ability to demonstrate to our potential customers and partners the value and benefits of new products;
- 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 or identity management solutions;
- the timing of large scale security programs involving smart cards and related technology by governments, banks and enterprises;
- the ability of financial institutions, corporate enterprises, the U.S. government and other governments to agree on industry specifications and to develop and deploy smart card-based applications that will drive demand for smart card readers and systems 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.

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.

For example, on October 1, 2008, we entered into a Stock Purchase Agreement with TranZfinity, Inc., a privately held entity, pursuant to which we purchased 33.7% of the outstanding shares of TranZfinity common stock for an aggregate purchase price of $2.5 million. During the fourth quarter of 2009, we determined that the value of our investment in TranZfinity was impaired and we recorded a charge for the impairment to write-off 100% of our investment and our proportionate losses realized by TranZfinity of $2.2 million.

On January 4, 2010, we acquired Bluehill ID AG, a Swiss stock corporation focused on investments in the security and RFID markets. Integrating the Bluehill ID business into our business exposes us to certain risks. The combination of companies is a complex, costly and time-consuming process. As a result, we must devote significant management attention and resources to integrating the diverse business practices and operations of the acquired company. The integration process may divert the attention of our executive officers and management from day-to-day operations and disrupt our businesses and, if implemented ineffectively, preclude realization of the full benefits expected from the transaction. Failure to meet the challenges involved in successfully integrating another company s operations with ours or otherwise to realize any of the anticipated benefits of an acquisition could cause an interruption of, or a loss of momentum in, the activities of our combined company and could adversely affect our results of operations. In addition, the integration of our two companies may result in unanticipated problems, expenses, liabilities, competitive responses and loss of customer relationships, and may cause our stock price to decline.

Any future acquisition could expose us to significant risks, including, without limitation, the use of our limited cash balance or potentially dilutive stock offerings to fund such acquisitions; costs of any necessary financing, which may not be available on reasonable terms or at all; accounting charges we might incur in connection with such acquisitions; the difficulty and expense of integrating personnel, technologies, customer, supplier and distributor relationships, marketing efforts and facilities acquired through acquisitions; integrating internal controls over financial reporting; discovering and correcting deficiencies in internal controls and other regulatory compliance, data adequacy and integrity, product quality and product liabilities; diversion of 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.

Acquisitions and strategic investments may also lead to substantial increases in non-current assets, including goodwill. Write-downs of these assets due to unforeseen business developments may materially and adversely impact our financial condition and results of operations.

Our business strategy also contemplates divesting portions of our business from time to time, if and when we believe we would be able to realize greater value for our stockholders in so doing. We have in the past sold, and may from time to time in the future sell, all or one or more portions of our business. Any divestiture or disposition could expose us to significant risks, including, without limitation, costly fees for legal and transaction-related services; diversion of management resources; loss of key personnel; and reduction in revenue. Further, we may be required to retain or indemnify the buyer against certain liabilities and obligations in connection with any such divestiture or disposition and we may also become subject to third-party claims arising out of such divestiture or disposition. In addition, we may not achieve the expected price in a divestiture transaction. Failure to overcome these risks could have a material adverse effect on our financial condition and results of operations.

Operational Risks

We have incurred and will incur significant expenses as a result of our acquisition strategy, which has reduced and will reduce the amount of capital available to fund our business.

We have incurred, and will continue to incur, significant expenses related to our acquisition strategy, including our acquisition of Hirsch in April 2009, our business combination with Bluehill ID in January 2010 and possible future acquisitions. These expenses include investment banking fees, legal fees, accounting fees, printing and mailing of stockholder materials, integration and other costs, as well as past and possible future outlays of cash. There may also be unanticipated costs related to our acquisition on an ongoing basis. As a result, the capital available to fund our activities has been and is expected to be further reduced. If we are unsuccessful in securing sufficient sales from established markets or in generating sufficient new revenues from emerging markets, then we would likely continue to require cash to fund our operations. The remaining cash available to us might not be adequate in subsequent years.

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We currently expect that our current capital resources should be sufficient to meet our operating and capital requirements at least through the end of 2010. 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.

We have incurred operating losses and may not achieve profitability.

We have a history of losses with an accumulated deficit of $216.4 million as of December 31, 2009. In the future, we may not be able to achieve expected results, including any guidance or outlook we may provide from time to time; we may continue to incur losses and we may be unable to achieve or maintain profitability.

Our quarterly and annual operating results fluctuate.

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

- business and economic conditions overall and in our markets;
- the timing and amount of orders we receive from our customers that may be tied to budgetary cycles, seasonal demand, product plans or program roll-out schedules;
- cancellations or delays of customer product orders or the loss of a significant customer;
- our ability to obtain an adequate supply of components on a timely basis;
- poor quality in the supply of our components;
- delays in the manufacture of our products;
- the absence of significant backlog in our business;
- our inventory levels;
- our customer and distributor inventory levels and product returns;
- competition;
- new product announcements or introductions;

our ability to develop, introduce and market new products and product enhancements on a timely basis, if at all;

our ability to successfully market and sell products into new geographic or market segments;

the sales volume, product configuration and mix of products that we sell;

technological changes in the markets for our products;

the rate of adoption of industry-wide standards;

reductions in the average selling prices that we are able to charge due to competition or other factors;

strategic acquisitions, sales and dispositions;

fluctuations in the value of foreign currencies against the U.S. dollar;

the timing and amount of marketing and research and development expenditures;

loss of key personnel; and

costs related to events such as dispositions, organizational restructuring, headcount reductions, litigation or write-off of investments or goodwill.

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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.

The pre-acquisition financial projections for both our business and Bluehill ID s business that were prepared in connection with our acquisition of Bluehill ID are only estimates of future results and there is no assurance that actual results will not be different.

In connection with the acquisition of Bluehill ID, we and Bluehill ID each created financial projections of our respective businesses. These financial projections are only estimates of possible future operating results and not guarantees of future performance. The future operating results of each company and of the combined company will be affected by numerous factors, including these Risk Factors. The actual operating results will likely differ from these financial projections.

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

In our ID Management business, sales tend to be relatively linear (regularly spaced throughout the quarter), as they are tied to projects with relatively predictable timelines. In our ID Products business, the main component of sales in any given quarter is sales is smart card reader technology. Historically, many of our smart card reader 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. As a result, smart card reader revenue in any quarter depends on contracts entered into or orders booked and shipped in that quarter. This makes it difficult to predict revenues both in our smart card reader business, and for the company overall. The timing of closing larger orders increases the risk of quarter-to-quarter fluctuation in revenues. If orders forecasted for a specific group of customers for a particular quarter are not realized or revenues are not otherwise recognized in that quarter, our operating results for that quarter could be materially adversely affected. In addition, from time to time, we may experience unexpected increases or decreases in demand for our products resulting from fluctuations in our customers budgets, purchasing patterns or deployment schedules. These occurrences are not always predictable and can have a significant impact on our results in the period in which they occur.

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.

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

If demand is less than anticipated, customers may ask that we accept returned products that they do not believe they can sell. We do not have a policy relating to product returns for the majority of our products. However, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. If we were to accept product returns, we may be required to take additional inventory reserves to reflect the decreased market value of slow-selling returned inventory, even if the products are in good working order.

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

In many of our product areas, our initial sales cycle for a new customer usually takes a minimum of six to nine months, and even in the case of established customers, it may take up to a year for us to receive approval for a given purchase from the customer. 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 SCM faces 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.

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.

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 42% of our revenue in fiscal 2009 and 58% of revenue in fiscal 2008. We expect that sales of our component products to a relatively small number of customers will continue to account for a significant percentage of our total sales for the foreseeable future, although the addition of Bluehill ID companies and customers should improve the diversity of our customer base and reduce our reliance on a small number of customers In our SCM Microsystems Digital Media and Connectivity business, approximately two-thirds of our business has typically been generated by two or three customers. The loss of a customer or reduction of orders from a significant customer, including those due to product performance issues, changes in customer buying patterns, or market, economic or competitive conditions in our market segments, could significantly lower our revenues in any period and would increase our dependence on a smaller group of our remaining customers. For example, in the first and fourth quarters of 2009, sales of our digital media readers were significantly lower than in previous quarters due to reduced orders from one major customer in this business. 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.

Our business could be adversely affected by significant changes in the contracting or fiscal policies of governments and governmental entities.

We derive a substantial portion of our revenues from contracts with international, federal, state and local governments and government agencies, and subcontracts under federal government prime contracts. We believe that the success and growth of our business will continue to be influenced by our successful procurement of government contracts either directly or through prime contractors. Accordingly, changes in government contracting policies or government budgetary constraints could directly affect its financial performance.

Among the factors that could adversely affect our government-related business are:

- changes in fiscal policies or decreases in available government funding or grants;
- changes in government programs or applicable requirements;
- the adoption of new laws or regulations or changes to existing laws or regulations;
- changes in political or social attitudes with respect to security and defense issues;
- potential delays or changes in the government appropriations process; and
- delays in the payment of its invoices by government payment offices.

These and other factors could cause governments and governmental agencies, or prime contractors that purchase our products or services, to reduce their purchases under existing contracts, to exercise their rights to terminate contracts at-will or to abstain from exercising options to renew contracts, any of which could have an adverse effect on our business, financial condition and results of operations. Many of our government customers are subject to stringent budgetary constraints. The award of additional contracts from government agencies could be adversely affected by existing or upcoming spending reduction efforts or budget cutbacks at these agencies.

Fluctuations in the valuation of foreign currencies could impact costs and/or revenues we disclose in U.S. dollars, and could result in foreign currency losses.

A significant portion of our business is conducted in foreign currencies, principally the euro. The portion of our business conducted in foreign currencies has increased since the Bluehill ID business combination as Bluehill ID conducts more than 95% of its business outside the U.S. Fluctuations in the value of foreign currencies relative to the U.S. dollar will continue to cause currency exchange gains and losses. If a significant portion of operating expenses are incurred in a foreign currency such as the euro, and revenues are generated in U.S. dollars, exchange rate fluctuations might have a positive or negative net financial impact on these transactions, depending on whether the U.S. dollar devalues or revalues compared to the euro. In addition, the valuation of current assets and liabilities that are denominated in a currency other than the functional currency can result in currency exchange gains and losses. For example, when an SCM subsidiary has the euro as the functional currency, and this subsidiary has a receivable in U.S. dollars, a devaluation of the U.S. dollar against the euro of 10% would result in a foreign exchange loss of the reporting entity of 10% of the value of the underlying U.S. dollar receivable. We cannot predict the effect of exchange rate fluctuations upon future quarterly and annual operating results. The effect of currency exchange rate changes may increase or decrease our costs and/or revenues in any given quarter, and we may experience currency losses in the future. To date, we have not adopted a hedging program to protect against risks associated with foreign currency fluctuations.

A significant portion of our revenue is dependent upon sales to government programs, which are impacted by uncertainty of timelines and budgetary allocations, delays in developing technology standards,

and changes in laws or regulations pertaining to security.

Large government programs are a primary target for our ID Management business, as higher security systems employing smart card technology are increasingly used to enable applications ranging from authorizing building and network access for federal employees to paying taxes online, to citizen identification, to receiving health care. Sales to U.S. government agencies and other entities comprise a significant portion of our sales. Additionally, we have sold a significant proportion of our smart card reader products to the U.S. government for PC and network access by military and federal employees, and these sales have been an important component of our overall revenue.

Government-sponsored projects are typically characterized by the uncertainty of their timelines and budget allocations and delays in developing technology standards to enable program applications. Additionally, many government programs are subject to changes in laws or regulations, such as those pertaining to authentication of government personnel, trade practices or health insurance documentation. Changes in fiscal policies or decreases in available government funding or grants could adversely affect our sales, as could changes in government programs or applicable requirements. Additionally, discontinuance of, changes in, or lack of adoption of laws or regulations pertaining to security could adversely affect our financial performance.

In recent periods, we have experienced a significant decrease in sales of our SCM Microsystems external smart card readers to the U.S. government, primarily due to weaker demand in this market as a result of ongoing project and budget delays and a movement by the U.S. government towards purchasing computer equipment with embedded reader capabilities. We continue to believe that we remain a leading supplier of smart card reader technology to the U.S. government market and that we are not losing share to competitors. However, lower overall market demand and the replacement of external smart card reader sales with sales of lower-priced interface chips for embedded readers is a trend that we do not think will reverse.

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We anticipate that a significant portion of our future revenues will come from government programs outside the U.S., such as national identity, e-government, e-health and others applications. We currently supply smart card readers for various government programs in Europe and Asia and are actively targeting additional programs in these areas as well as in Latin America. We also have spent significant resources developing a range of e-health smart card terminals for the German government s electronic health card program. However, the timing of government smart card programs is not always certain and delays in program implementation are common. For example, while the German government had stated that it planned to distribute new electronic health cards to its citizens beginning in early 2009, and to put in place a corresponding network and card reader infrastructure during 2009, there have been delays in this program and the actual timing of equipment and card deployments in the German e-health program remain uncertain. The continued delay of government projects for any reason could negatively impact our sales.

We derive a substantial portion of revenue through the sale of Hirsch solutions to U.S. government entities, pursuant to government contracts which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our revenues and earnings.

Government contracts frequently include provisions that are not standard in private commercial transactions. For example, government contracts may include bonding requirements and provisions permitting the purchasing agency to cancel or delay the contract without penalty in certain circumstances. In addition, government contracts are frequently awarded only after formal competitive bidding processes, which have been and may continue to be protracted, and typically impose provisions that permit cancellation in the event that necessary funds are unavailable to the public agency. In many cases, unsuccessful bidders for government agency contracts are provided the opportunity to formally protest certain contract awards through various agency, administrative and judicial channels. The protest process may substantially delay a successful bidder s contract performance, result in cancellation of the contract award entirely and distract management. We may not be awarded contracts for which we bid, and substantial delays or cancellation of purchases may even follow our successful bids as a result of such protests. Furthermore, local government agency contracts may be contingent upon availability of matching funds from federal or state entities. Law enforcement and other government agencies are subject to political, budgetary, purchasing and delivery constraints which may cause our quarterly and annual revenues and operating results to fluctuate in a manner that is difficult to predict.

Our U.S. government business is dependent upon receipt of certain governmental approvals or certifications, and failure to receive such approvals or certifications could have a material adverse effect on

our sales in those market segments for which such approvals or certifications are customary or required.

The U.S. federal government represents a significant portion of our revenues. Failing to obtain certain government approvals or certifications could have a material adverse effect in those market segments for which such approvals or certifications are customary or required. As newer versions of existing products, or new products in development, are released, they may require certifications or approvals. In addition, the government may introduce new requirements that some existing products will be required to meet. If we fail to obtain any required approvals or certifications for our products, our business will suffer.

Our business could be adversely affected by negative audits by government agencies; we could be required to reimburse the U.S. government for costs that we have expended on government contracts; and our

ability to compete successfully for future contracts could be materially impaired.

Government agencies may audit our business as part of their routine audits and investigations of government contracts. As part of an audit, these agencies may review our performance on contracts, cost structures and compliance with applicable laws, regulations and standards. These agencies may also review the adequacy of, and our compliance with, our own internal control systems and policies, including our purchasing, property, estimating, compensation and management information systems. If any of our costs are found to be improperly allocated to a specific contract, the costs may not be reimbursed and any costs already reimbursed for such contract may have to be refunded. An audit could materially affect our business competitive position and result in a material adjustment to our financial results or statement of operations. If a government agency audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with the federal government. In addition, our business could suffer serious harm to its reputation if allegations of impropriety were made against it.

While our business has never had a negative audit by a governmental agency, we cannot assure you that one will not occur. If we were suspended or barred from contracting with the federal government generally, or if our reputation or relationships with government agencies were impaired, or if the government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our revenues and prospects would be materially harmed.

Some of our sales are made through distributors, and the loss of such distributors could result in decreased revenue.

We currently use distributors to sell some of our products, primarily into markets or customers where the distributor may have closer relationships or greater access than we do. Some of these distributors also sell our competitors products, and if they favor our competitors products for any reason, they may fail to market our products as effectively or to devote resources necessary to provide effective sales, which would cause our sales to suffer. Distribution arrangements are intended to benefit both us and the distributor, and may be long- or short-term relationships, depending on market conditions, competition in the marketplace and other factors. If we are unable to maintain effective distribution channels, there could be a reduction in the amount of product we are able to sell, and our revenues could decrease.

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

Many of the Company s products are manufactured outside the U.S. 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;
- export controls;
- political and economic instability;
- lack of control over the manufacturing process and ultimately over the quality of our products;

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

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

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

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

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

We rely upon a limited number of suppliers for some key components of our products. For example, we currently utilize the foundry services of external suppliers to produce our ASICs for smart cards readers, and we use chips and antenna components from third-party suppliers in our contactless smart card readers. Our reliance on a limited number of suppliers may expose us to various risks including, without limitation, an inadequate supply of components, price increases, late deliveries and poor component quality. In addition, some of the basic components used in our digital media reader business, such as digital flash media, may at any time be in great demand. This could result in components not being available to us in a timely manner or at all, particularly if larger companies have ordered more significant volumes of those components, or in higher prices being charged for components. Disruption or termination of the supply of components or software used in our products could delay shipments of our 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.

Security breaches in systems we sell or maintain could result in the disclosure of sensitive government information or private personal information that could result in the loss of clients and negative publicity.

Many of the systems we sell manage private personal information and protect information involved in sensitive government functions. A security breach in one of these systems could cause serious harm to our business as a result of negative publicity and could prevent us from having further access to such systems or other similarly sensitive areas for other governmental clients.

As part of our technical support services, we agree, from time to time, to possess all or a portion of the security system database of our customers. This service is subject to a number of risks. For example, our systems may be vulnerable to physical or electronic break-ins and service disruptions that could lead to interruptions, delays or loss of data. If any such compromise of our security were to occur, it could be very expensive to correct, could damage our reputation and could discourage potential customers from using our services. Although we have not experienced attempted break-ins, we may experience such attempts in the future. Our systems may also be affected by outages, delays and other difficulties. Our insurance coverage may be insufficient to cover losses and liabilities that may result from such events.

Failure to properly manage the implementation of customer projects in our business may result in costs or claims against us, and our financial results could be adversely affected.

In our business, deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the implementation of our solutions in such projects and to deploy appropriate resources, including our own project managers and third-party subcontractors, in a timely manner. Any defects or errors or failures to meet clients expectations could result in damage to our reputation or even claims for

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substantial monetary damages against us. In addition, we sometimes provide guarantees to customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit derived from a particular project. Moreover, a portion of our revenues are derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

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 SCM Microsystems smart card readers, Hirsch s control panels and readers and TagStar s inlays 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. 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 Secure Authentication 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 possible 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.

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 Australia, Brazil, Canada, Germany, Hong Kong, India, Italy, Japan, the Netherlands, Switzerland and the U.S. We also must manage contract manufacturers in multiple countries, including China and Singapore. Managing our various development, sales, administrative and manufacturing operations places a significant burden on our financial systems and has contributed to a level of operational spending that is disproportionately high compared to our current revenue levels.

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

- divert a significant amount of time and energy to manage employees and contractors from diverse cultural backgrounds and who speak different languages;
- travel between our different company offices;
- maintain sufficient internal financial controls in multiple geographic locations that may have different control environments;
- manage different product lines for different markets;
- manage our supply and distribution channels across different countries and business practices; and
- coordinate these efforts to produce an integrated business effort, focus and vision.

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

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

operation.

We conduct a substantial portion of our business in Europe and Asia. Approximately 40% of our revenue for fiscal 2009, 57% of our revenue for fiscal 2008 and 49% of our revenue for fiscal 2007 was derived from customers located outside the U.S. Our recent acquisition of Bluehill ID further increases our non-US business, as Bluehill ID conducts a substantial portion of its business in Germany, and in the rest of Europe, Canada, Brazil, and Australia. Nearly all of Bluehill ID s revenue for the year ended December 31, 2009 and approximately 98% of revenue for the year ended December 31, 2008 was derived from customers located outside the U.S.

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;

export controls;

potentially adverse tax consequences;

longer accounts receivable collection cycles;

difficulty in managing widespread sales and manufacturing operations; and

less effective protection of intellectual property.

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Personnel Risks

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

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

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

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

Risks of Financial and Capital Markets

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, particularly 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.

SCM common stock has historically traded at a very low volume. The market price of SCM common stock could decline as a result of the large number of shares that have been issued to the former Hirsch and

Bluehill ID shareholders and that are currently eligible for sale or securities that have been issued to the former Hirsch shareholders that will become exercisable for shares of SCM common stock in the future.

The new shares of SCM common stock issued as consideration in connection with the acquisition of Hirsch became freely saleable on January 30, 2010 and the warrants to purchase shares of SCM common stock will be exercisable for a two year period beginning on April 30, 2012. The new shares of SCM common stock issued to former Bluehill ID shareholders in the business combination with Bluehill ID are unrestricted and can be freely traded. Consequently, a substantial number of additional shares of SCM common stock have recently become available for resale in the public market. Stockholders of SCM and former shareholders of Hirsch or Bluehill ID may not wish to continue to invest in the operations of the company or may wish to dispose of some or all of their interests in SCM. Sales of substantial numbers of shares of both the newly issued and the existing SCM common stock in the public market could adversely affect the market price of our 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.

In connection with the acquisition of Hirsch on April 30, 2009, after giving effect to the acquisition, we issued approximately 9.4 million shares of SCM common stock, and warrants to purchase approximately 4.7 million shares of SCM common stock, as consideration for the outstanding shares of Hirsch common stock. In connection with our business combination with Bluehill ID on January 4, 2010, we issued approximately 15.3 million shares of SCM common stock as consideration for the outstanding shares in Bluehill ID that were tendered in the transaction. From time to time, in the future we also may issue additional 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 60,000,000 shares of common stock. At our 2010 Annual Meeting of Stockholders our stockholders will be considering a proposal to increase the number of authorized shares of common stock by 20,000,000 shares to a total of 80,000,000 shares of common stock. As of March 5, 2010, 39,160,319 shares of common stock were outstanding.

In 2007, our Board of Directors and our stockholders approved our 2007 stock option plan, under which, as amended in October 2009, options to purchase 3.5 million shares of our common stock may be granted. As of December 31, 2009, an aggregate of approximately 4.8 million shares of common stock was reserved for future issuance under all our stock option plans, of which 2.4 million shares were subject to outstanding options. We may issue additional shares of our common stock or other securities that are convertible into or exercisable for shares of 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. Additionally, as of December 31, 2009, warrants to purchase approximately 4.9 million shares of SCM common stock were outstanding.

The issuance of additional shares of common stock or preferred stock or other securities, or the perception that such issuances could occur, may create downward pressure on the trading price of our common stock. In addition, the lock-up placed on the shares of our common stock issued to former Hirsch shareholders in connection with the merger of SCM and Hirsch which have restricted their transfer or sale released in its entirety on January 30, 2010, which could add additional downward pressure on the trading price of SCM common stock.

The large percentage ownership of SCM common stock by former shareholders of Hirsch and Bluehill ID gives those shareholders significant influence over the outcome of corporate actions requiring stockholder

approval.

As a result of our acquisitions of Hirsch and Bluehill ID, the former Hirsch shareholders beneficially own approximately 22% and the former Bluehill ID shareholders beneficially own approximately 38% of SCM s common stock. Accordingly, the former Hirsch and Bluehill ID shareholders hold significant influence over the outcome of any corporate transaction or other matter submitted to the SCM stockholders for approval, including the election of directors, any merger, consolidation or sale of all or substantially all of SCM s assets or any other significant corporate transaction, such that such former shareholders of Hirsch or Bluehill ID could delay or prevent a change of control of SCM, even if such a change of control would benefit our other stockholders. The interests of the former Hirsch and Bluehill ID shareholders may differ from the interests of other stockholders.

Several of our directors directly or indirectly hold significant amounts of our common stock, and each of them could have significant influence over the outcome of corporate actions requiring board and stockholder

approval, respectively. In some cases, their priorities for our business may be different from ours or our other stockholders.

As of January 4, 2010, Mountain Partners AG, together with its affiliates and certain related parties, including Mountain Partners Angel Fund and BH Capital Management (collectively Mountain Partners), directly or indirectly owned approximately 20.5% of the outstanding common shares of our common stock and had the right to vote approximately 14.8% of the outstanding shares of our common stock. Daniel Wenzel, a director of our Company, is a co-founder and current affiliate of Mountain Partners and also may be deemed to beneficially own, either directly or indirectly through limited partnerships, the SCM shares beneficially owned by Mountain Partners. Additionally, Mr. Wenzel and Ayman S. Ashour, our Chief Executive Officer and Chairman, are also affiliates of BH Capital Management AG, which is 51% owned by Mountain Partners AG and which at January 4, 2010 owned and had the right to vote approximately 5.7% of the outstanding shares of our common stock. Consequently Messrs. Ashour and Wenzel also may be deemed to beneficially own, either directly or indirectly through limited partnerships, the SCM shares beneficially owned by BH Capital Management AG. As of January 4, 2010, Lincoln Vale owned and had the right to vote approximately 8.1% of the outstanding shares of our common stock. Dr. Hans Liebler, one of our directors, is a partner of Lincoln Vale and also may be deemed to beneficially own, either directly or indirectly through limited partnerships, the SCM shares beneficially owned by Lincoln Vale. As of January 4, 2010, Lawrence Midland, a director and an executive vice president of SCM, held approximately 3.3% of our common stock. Mr. Midland s shares are held in a family trust and in custodianship for his children, and he may be deemed to beneficially own the SCM shares.

Accordingly, Mr. Ayman, Dr. Liebler, Mr. Midland, Mr. Wenzel, BH Capital Management AG, Lincoln Vale and Mountain Partners could each have significant influence over the outcome of corporate actions requiring board and stockholder approval, respectively, including the election of directors, any merger, consolidation or sale of all or substantially all of our assets or any other significant corporate transaction. In addition, Mr. Ayman, Dr. Liebler, Mr. Midland, Mr. Wenzel, BH Capital Management AG, Lincoln Vale and Mountain Partners could each delay or prevent a change of control of SCM, even if such a change of control would benefit our other stockholders.

Shares of SCM common stock beneficially owned by our largest investors will count toward whether a quorum is achieved.

To achieve a quorum at SCM s annual stockholder meeting requires at least one-third of all shares of SCM s stock entitled to vote be present in person or by proxy at the SCM annual meeting. If the shares beneficially owned by each of Lincoln Vale, Mountain Partners and BH Capital Management AG (including the interests of Messrs. Ashour, Liebler and Wenzel) are present in person or by proxy at the SCM annual meeting, they will contribute approximately 28.6% toward the 33.3% of shares of SCM common stock required to achieve a quorum.

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 the majority 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 U.S. to events such as acquisitions, dispositions, one-time charges and higher or lower than expected revenue or earnings announcements. A significant 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.

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

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

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

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

Legal and Regulatory Risks

Our business could be adversely affected by changes in laws or regulations pertaining to security.

The U.S. federal government, contractors to the federal government and certain industries in the public sector currently fall, or may in the future fall, under particular regulations pertaining to security. Some of the laws, regulations, certifications or requirements that may stimulate new security systems sales include the following:

- Homeland Security Presidential Directive (HSPD) 12 and Federal Information Processing Standards (FIPS) 201 produced by National Institute of Standards and Technology (NIST);
- Federal Information Security Management Act (FISMA);
- Transportation Security Administration s (TSA) Transportation Worker Identification Credential (TWIC) program;
- Sarbanes-Oxley Act of 2002 (also known as the Public Company Accounting Reform and Investor Protection Act);
- Health Insurance Portability and Accountability Act (HIPAA);
- Gramm-Leach Bliley Act of 1999 (GLBA, a.k.a., the Financial Modernization Act);

Customs-Trade Partnership Against Terrorism (C-TPAT);

Free and Secure Trade Program (FAST);

Chemical Facility Anti Terrorism Standards (CFATS); and

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various codes of the Code of Federal Regulations (CFR).

Discontinuance of, changes in, or lack of adoption of laws or regulations pertaining to security could adversely affect our performance.

We are subject to extensive government regulation, and any failure to comply with applicable regulations could subject us to penalties that may restrict our ability to conduct our business.

Our business is affected by and must comply with various government regulations that impact its operating costs, profit margins and its internal organization and operations. Furthermore, our business may be audited to assure compliance with these requirements. Any failure to comply with applicable regulations, rules and approvals could result in the imposition of penalties, the loss of government contracts or the cancellation of our General Services Administration contract, any of which could adversely affect our business, financial condition and results of operations. Among the most significant regulations affecting our business are the following:

- the Federal Acquisition Regulations, or the FAR, and agency regulations supplemental to the FAR, which comprehensively regulate the formation and administration of, and performance under government contracts;
- the Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations;
- the Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under cost-based government contracts;
- the Foreign Corrupt Practices Act; and
- laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

These regulations affect how our customers can do business with us, and, in some instances, the regulations impose added costs on our business. Any changes in applicable laws and regulations could restrict our ability to conduct our business. Any failure to comply with applicable laws and regulations could result in contract termination, price or fee reductions or suspension or debarment from contracting with the federal government generally.

If we are unable to continue to obtain U.S. government authorization regarding the export of our products, or if current or future export laws limit or otherwise restrict our business, we could be prohibited

from shipping our products to certain countries, which could cause our business, financial condition and results of operations to suffer.

In our business, we must comply with U.S. and European Union (EU) laws, among others, regulating the export of our products. In some cases, explicit authorization from the U.S. or an EU government is needed to export our products. The export regimes and the governing policies applicable to our business are subject to changes. We cannot be certain that such export authorizations will be available to us or for our products in the future. In some cases, we rely upon the compliance activities of our prime contractors, and we cannot be certain they have taken or will take all measures necessary to comply with applicable export laws. If we or our prime contractor partners cannot obtain required government approvals under applicable regulations, we may not be able to sell our products in certain international jurisdictions.

We face risks from future claims of third parties and litigation.

From time to time, we may be subject to claims of third parties, possibly resulting in litigation, which could include, among other things, claims regarding infringement of the intellectual property rights of third parties, product defects, employment-related claims, and claims related to acquisitions, dispositions or restructurings.

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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 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 U.S. Because many of our products are sold and a significant portion of our business is conducted outside the U.S., 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 in tax laws or the interpretation thereof, adverse tax audits and other tax matters may adversely affect our future results.

A number of factors may impact our tax position, including:

- the jurisdictions in which profits are determined to be earned and taxed;
- the resolution of issues arising from tax audits with various tax authorities;
- changes in the valuation of our deferred tax assets and liabilities;

adjustments to estimated taxes upon finalization of various tax returns;

increases in expenses not deductible for tax purposes; and

the repatriation of non-U.S. earnings for which we have not previously provided for U.S. taxes.

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

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

We prepare our financial statements to conform with U.S. GAAP. These accounting principles are subject to interpretation by the Financial Standards Accounting Board, the American Institute of Certified Public Accountants, the SEC and various other bodies formed to interpret and create appropriate accounting rules and policies. A change in those rules or policies could have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Any changes in accounting rules or policies in the future may result in significant accounting charges.

We face costs and risks associated with maintaining effective internal controls over financial reporting, and if we fail to achieve and maintain adequate internal controls over financial reporting, our business,

results of operations and financial condition, and investors confidence in us could be materially affected.

Under Sections 302 and 404 of the Sarbanes-Oxley Act of 2002, our management is required to make certain assessments and certifications regarding our disclosure controls and internal controls over financial reporting. We have dedicated, and expect to continue to dedicate, significant management, financial and other resources in connection with our compliance with Section 404 of the Sarbanes-Oxley Act. The process of maintaining and evaluating the effectiveness of these controls is expensive, time-consuming and requires significant attention from our management and staff. During the course of our evaluation, we may identify areas requiring improvement and may be required to design enhanced processes and controls to address issues identified through this review. This could result in significant delays and costs to us and require us to divert substantial resources, including management time from other activities. We have found a material weakness in our internal controls in the past and we cannot be certain in the future that we will be able to report that our controls are without material weakness or to complete our evaluation of those controls in a timely fashion.

If we fail to maintain an effective system of disclosure controls or internal control over financial reporting, we may not be able to rely on the integrity of our financial results, which could result in inaccurate or late reporting of our financial results and investigation by regulatory authorities. If we fail to achieve and maintain adequate internal controls the financial position of our business could be harmed; current and potential future shareholders could lose confidence in us and/or our reported financial results, which may cause a negative effect on the trading price of our common stock; and we could be exposed to litigation or regulatory proceedings, which may be costly or divert management attention.

In addition, all internal control systems, no matter how well designed and operated, can only provide reasonable assurance that the objectives of the control system are met. Because there are inherent limitations in all control systems, no evaluation of control can provide absolute assurance, that all control issues and instances of fraud, if any, within the Company have been or will be detected. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Any failure of our internal control systems to be effective could adversely affect our business.

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Following the business combination with Bluehill ID, we will continue to incur significant costs as a result of operating as a public company, and our management may be required to devote substantial time to

compliance initiatives.

As a U.S. public company, the Company currently incurs significant legal, accounting and other expenses. In addition, the Sarbanes-Oxley Act, as well as rules subsequently implemented by the SEC and the NASDAQ Stock Market, have imposed various requirements on public companies, including requiring establishment and maintenance of effective disclosure and financial controls and changes in corporate governance practices. Our management and other personnel devote a substantial amount of time and financial resources to these compliance initiatives. Following the completion of an acquisition, the acquired business becomes a subsidiary of the Company and is subject to the Sarbanes-Oxley Act, and the Company continue to be subject to all of the same obligations. Bringing an acquired company into compliance requires significant expenditures and places additional demands on the Company s management and may divert our management s time and attention away from the day-to-day operations of the business. These obligations may also require us to hire additional personnel following any acquisition.

The integration of our Hirsch operations and the work to bring Hirsch into compliance with Sarbanes-Oxley regulations is ongoing and we expect it will be substantially completed by the end of the first quarter of 2010. Bluehill ID is currently evaluating its internal controls systems in order to enable the Company to report on, and SCM s independent registered public accounting firm after the business combination to attest to, internal controls, as required by Section 404 of the Sarbanes-Oxley Act. The Company and Bluehill ID cannot be certain as to the timing of completion of the evaluation, testing and remediation actions or the impact of the same on the operations of the Company after the business combination. If, after the business combination, we fail to staff our accounting and finance function adequately, or maintain internal controls adequate to meet the demands that are placed upon us as a U.S. public company, including the requirements of the Sarbanes-Oxley Act, we may be unable to report our financial results accurately or in a timely manner and our business and stock price may suffer. The costs of being a public company, as well as diversion of management s time and attention, may have a material adverse effect on our future business, financial condition and results of operations.

Qualified management, marketing, and sales personnel are difficult to locate, hire and train, and if we cannot attract and retain qualified personnel, it will harm the ability of our business to grow.

The success of our company depends, in part, on the continued service of key managerial, marketing and sales personnel. Competition for qualified management, technical, sales and marketing employees is intense. We cannot assure you that we will be able to attract, retain and integrate employees to develop and continue our business and strategies as a combined company.

We may not have uncovered all the risks associated with the acquisition of Bluehill ID and a significant liability may be discovered in the future.

There may be risks that we failed to discover in the course of performing our due diligence investigations related to the acquisition of Bluehill ID, which could result in significant liabilities arising in the future. The business combination agreement does not provide for the Company s indemnification by the former Bluehill ID shareholders against any of Bluehill ID s liabilities, should they arise or become known after the closing of the offer. Furthermore, there is no escrow account or indemnity agreement protecting us in the event of any breach of Bluehill ID s representations and warranties in the business combination agreement. Any significant liability that may arise may harm our business, financial condition, results of operations and prospects by requiring us to expend significant funds to satisfy such liability.

Bluehill ID s corporate records may be incomplete.

Certain Bluehill ID Group Companies were not able to provide SCM with complete corporate records as part of the due diligence process in order to document the history of their share ownership, and certain share

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transfers may be non-compliant with form requirements applicable to such share transfer. Besides uncertainties as to the ownership in any such Bluehill ID Group Company, this could result in difficulties with performing corporate functions, future challenges to shareholders resolutions passed or potential litigation involving the Bluehill ID Group Company concerned. Any of the foregoing may have a material adverse effect on our business, financial condition or its results of operations.

ITEM 1B. ***UNRESOLVED STAFF COMMENTS***

None.

ITEM 2. ***PROPERTIES***

Our corporate headquarters are co-located with our Hirsch business headquarters in Santa Ana, California, where we lease approximately 34,599 square feet pursuant to a lease agreement that expires in November 2012. Our European operational headquarters are in Ismaning Germany, where we lease approximately 22,000 square feet pursuant to a lease agreement that expires in November 2013. We also lease a 2,100 square foot sales and marketing facility in Japan, pursuant to a lease agreement that expires in September 2010. We lease a research and development facility of approximately 17,600 square feet in Chennai, India. We consider these properties as adequate for our business needs.

We also lease approximately 69,000 square feet at a facility in Guilford, Connecticut, where the lease term expires February 2011. During 2003, we discontinued operations at the Guilford facility and we are currently attempting to sublease the unused space.

ITEM 3. ***LEGAL PROCEEDINGS***

From time to time, we 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, 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 4. ***SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS***

At our Annual Meeting of Stockholders held on October 29, 2009, at which a quorum of 15,364,579 shares of shares of common stock issued and outstanding were represented in person or by proxy, the following matters were acted upon by the stockholders of the Company:

1. To elect three Class II directors to serve as Class II directors of the Company for a term of three years or until such time as their respective successors are duly elected and qualified.

	For	Withheld
Werner Koepf	15,136,942	227,637
Lawrence W. Midland	15,084,063	280,516
Simon Turner	15,137,063	227,516

2. To approve the amendment of the Company s Certificate of Incorporation to increase the amount of Common Stock authorized under the Company s Certificate of Incorporation by 20,000,000 shares.

For	Against	Abstain
14,943,059	347,090	74,390

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3. To approve the amendment of the Company s 2007 Stock Option Plan to increase the number of shares reserved for issuance under the 2007 Stock Option Plan by 2,000,000 shares.

For	Against	Abstain
12,455,164	2,068,875	840,040

4. To ratify the appointment of Deloitte & Touche as independent registered public accountants of the Company for the fiscal year ended December 31, 2009.

For	Against	Abstain
15,217,037	121,641	25,901

At a Special Meeting of our stockholders held on December 18, 2009, at which a quorum of 12,049,313 shares of common stock issued and outstanding were represented in person or by proxy, the following matters were acted upon by the stockholders of the Company:

1. To approve the offer by SCM to acquire all of the issued and outstanding shares in Bluehill ID AG, and specifically, the issuance of new shares SCM common stock, par value $0.001 per share, in connection with the offer, to effect the business combination proposed under the Business Combination Agreement, dated as of September 20, 2009, as amended October 20, 2009, by and among SCM and Bluehill ID AG, a stock corporation incorporated in Switzerland.

For	Against	Abstain
11,832,701	213,612	3,000

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PART II

ITEM 5. ***MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES***

Price Range of Common Stock; Number of Holders; Dividends

Our common stock is traded on the NASDAQ Stock Market s National Market under the symbol INVE and on the Prime Standard of the Frankfurt Stock Exchange under the symbol INV. According to data available at March 5, 2010, we estimate we had approximately 2,000 stockholders of record and beneficial stockholders. Not represented in this figure are individual stockholders in Germany whose custodian banks do not release stockholder information to us. The following table sets forth the high and low closing prices of our common stock for the periods indicated.

	NASDAQ National Market		Prime Standard (Quoted in Euros)	
	High	**Low**	**High**	**Low**
Fiscal 2009:				
First Quarter	$ 2.88	$ 1.97	2.08	1.48
Second Quarter	$ 3.20	$ 2.13	2.01	1.50
Third Quarter	$ 2.92	$ 2.04	1.98	1.47
Fourth Quarter	$ 3.00	$ 2.37	2.02	1.60
Fiscal 2008:				
First Quarter	$ 3.78	$ 2.59	2.56	1.71
Second Quarter	$ 3.19	$ 2.71	1.99	1.68
Third Quarter	$ 3.17	$ 2.08	2.03	1.52
Fourth Quarter	$ 2.34	$ 1.27	1.62	1.02

We have never declared or paid cash dividends on our common stock or other securities. We currently anticipate that we will retain all of our future earnings for use in the expansion and operation of our business and do not anticipate paying any cash dividends in the foreseeable future.

The disclosure required by Item 201(d) of Regulation S-K is included in Item 12 of this Annual Report on Form 10-K.

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Stock Performance Graph

The following performance graph compares the cumulative total return to holders of our common stock since December 31, 2004, to the cumulative total return over such period of the NASDAQ Composite index and the RDG Technology Index.

The performance graph assumes that $100 was invested on December 31, 2004 in our common stock and in each of the comparative indices. The performance graph further assumes that such amount was initially invested in our common stock at a price of $4.87 per share, the closing price on December 31, 2004.

Our historic stock price performance is not necessarily indicative of future stock price performance.

Measurement Period (Fiscal Year Covered)	**SCM Microsystems**	**NASDAQ Composite**	**RDG Technology**
Dec-04	100	100	100
Dec-05	70	101	102
Dec-06	64	114	111
Dec-07	69	124	127
Dec-08	46	73	72
Dec-09	49	106	116

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Recent Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

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ITEM 6. ***SELECTED FINANCIAL DATA***

The table below has been restated to account for the sale of our DTV solutions business in fiscal 2006 and the sale of our retail Digital Media and Video business in fiscal 2003, with both businesses accounted for as discontinued operations. 2009 figures include eight months of operating results for Hirsch, which was acquired on April 30, 2009.

SCM MICROSYSTEMS, INC.

SELECTED CONSOLIDATED FINANCIAL DATA

	Years Ended December 31, (In thousands, except per share data)				
	2009	**2008**	**2007**	**2006**	**2005**
Consolidated Statement of Operations Data:					
Net revenue	$ 41,315	$ 28,362	$ 30,435	$ 33,613	$ 27,936
Cost of revenue	22,804	15,817	17,781	21,756	17,106
Gross profit	18,511	12,545	12,654	11,857	10,830
Operating expenses:					
Research and development	5,062	3,902	3,123	3,767	4,081
Selling and marketing	15,584	9,620	6,603	7,498	7,040
General and administrative	12,091	8,075	7,128	7,548	9,198
Amortization of intangibles			272	666	673
Impairment of intangibles	647				
Restructuring and other charges				1,120	319
Gain on sale of assets	(1,417)	(1,455)			
Total operating expenses	31,967	20,142	17,126	20,599	21,311
Loss from operations	(13,456)	(7,597)	(4,472)	(8,742)	(10,481)
Loss on equity investments	(2,244)	(256)			
Interest (expense) income	(487)	757	1,639	1,350	745
Foreign currency gains (losses)	76	(2,638)	(346)	(225)	1,731
Loss from continuing operations before income taxes	(16,111)	(9,734)	(3,179)	(7,617)	(8,005)
Benefit (provision) for income taxes	1,549	(752)	(113)	(73)	(150)
Loss from continuing operations	(14,562)	(10,486)	(3,292)	(7,690)	(8,155)
Gain (loss) from discontinued operations, net of income taxes	226	(213)	(215)	3,508	(2,109)
Gain (loss) on sale of discontinued operations, net of income taxes	157	589	1,586	5,224	(2,171)
Net (loss) income	$ (14,179)	$ (10,110)	$ (1,921)	$ 1,042	$ (12,435)
Basic and diluted loss per share from continuing operations	$ (0.66)	$ (0.66)	$ (0.21)	$ (0.49)	$ (0.53)
Basic and diluted income (loss) per share from discontinued operations	$ 0.02	$ 0.02	$ 0.09	$ 0.56	$ (0.27)
Basic and diluted net (loss) income per share	$ (0.64)	$ (0.64)	$ (0.12)	$ 0.07	$ (0.80)
Shares used to compute basic and diluted (loss) income per share	22,013	15,743	15,725	15,638	15,532

	December 31,				
	2009	**2008**	**2007**	**2006**	**2005**
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 4,836	$ 20,550	$ 32,444	$ 36,902	$ 32,440

Working capital(1)	4,114	23,931	34,027	31,967	27,371
Total assets	64,571	41,138	48,564	51,355	52,734
Total stockholders equity	37,940	28,126	37,039	35,318	32,617

(1) Working capital is defined as current assets less current liabilities

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ITEM 7. ***MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS***

The following information should be read in conjunction with the audited consolidated financial statements and notes thereto included in Item 8 of this Annual Report on Form 10-K. We also urge readers to review and consider our disclosures describing various factors that could affect our business, including the disclosures under the headings Risk Factors in this Annual Report on Form 10-K.

Overview

We are an international technology group focused on building the world s signature company in secure identification-based technologies. Through our group of recognized brands, we provide leading-edge products and solutions in the areas of physical and logical access control, identity management and radio frequency identification (RFID) systems to governments, commercial and industrial enterprises and consumers. Our growth model is based on a combination of disciplined acquisitive development and strong technology-driven organic growth from our member companies.

We adopted a new organizational structure in January 2010 following our business combination with Bluehill ID, a Swiss industrial holding group focused on investments in the RFID/identification and security industries. We are now doing business as Identive Group and intend to seek stockholder approval at our 2010 Annual Meeting of Stockholders to amend our certification of incorporation to legally change the name of the Company to Identive Group, Inc. Following the acquisition of Bluehill ID, we are now comprised of a group of companies with deep industry expertise and well-known global brands in their individual markets. At the corporate level, we provide operational support and expertise to facilitate sharing of technology and resources to help our individual companies expand and compete more effectively in the global marketplace. Individual businesses within the Company include Hirsch Electronics, SCM Microsystems, Multicard, TagStar Systems, Arygon Technologies, ACiG Technology and Syscan ID.

We acquired Bluehill ID on January 4, 2010, and will begin reporting consolidated results including Bluehill ID beginning in the first quarter of 2010.

Highlights of the Fourth Quarter, Ending December 31, 2009:

- Financial results for the 2009 fourth quarter include the results of the Hirsch business, which we acquired on April 30, 2009 and consolidated as a wholly-owned subsidiary.

- Net revenues were $11.9 million in the fourth quarter of 2009, up about a third compared to the same quarter a year earlier due to incremental revenue from Hirsch. Excluding Hirsch, revenues were down more than a third from the previous year.

- We overall posted an after-tax loss from continuing operations of $(8.5) million in the fourth quarter of 2009 compared to a loss from continuing operations of $(3.7) million in the same quarter of the previous year. This included approximately $1.3 million in transaction expenses primarily related to our acquisition of Bluehill ID and a loss on equity investments of approximately $1.4 million. Our net loss for the fourth quarter of 2009, including discontinued operations, was $(8.4) million, compared to a loss of $(4.1) million in the fourth quarter of 2008.

- In December 2009, both our stockholders and the shareholders of Bluehill ID approved the proposed business combination between the two companies, and the transaction subsequently closed on January 4, 2010.

Narrative Summary of the 2009 Fourth Quarter

During the fourth quarter of 2009, we continued our integration of the Hirsch business and announced our proposed business combination with Bluehill ID AG. The Bluehill ID transaction closed on January 4, 2010.

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Both the Hirsch and Bluehill ID acquisitions were strategic moves aimed at rapidly increasing our revenues, scale and ability to address the high growth markets for identification and identity management solutions.

With the addition of revenue from Hirsch, revenues increased 32% in the fourth quarter of 2009 compared with the fourth quarter of 2008. Excluding Hirsch, fourth quarter 2009 revenues were down 36% from the same period of the previous year. Sales of our Hirsch products in the 2009 fourth quarter were up year over year. U.S. sales of our SCM branded smart card reader products were very weak in the 2009 fourth quarter as a result of delays in orders from our end customers in the government sector. Sales of our smart card reader products in Asia remained strong and grew significantly compared with the fourth quarter of 2008. Sales of smart card reader products in Europe were moderately lower in the 2009 fourth quarter compared with the same period of the prior year. At the same time, sales of our eHealth terminals for the electronic healthcard program in Germany continued to be significantly lower than expected in the 2009 fourth quarter, due to continued delays in implementation of the program by the German government authorities. Sales of our digital media reader products were also very weak in the fourth quarter of 2009 as a result of loss of new orders as a major customer ceased adding new kiosks in light of reduced consumer usage of photo kiosks due to the economic downturn.

Our overall gross margin fell to 37% in the fourth quarter of 2009 from 46% in the same quarter of 2008, as a result of a write-off of inventory of $0.8 million related to our terminals for the stalled German eHealth program. Operating expenses were 111% higher in the fourth quarter of 2009 compared with the fourth quarter of 2008, primarily due to the inclusion of operating expenses relating to the Hirsch business, as well as $1.3 million in transaction costs primarily related to our acquisition of Bluehill ID. Including a loss on investments of $1.4 million, we posted an after-tax loss from continuing operations of $(8.5) million in the fourth quarter of 2009, compared to a loss from continuing operations of $(3.7) million in the fourth quarter of 2008. Our net loss for the fourth quarter of 2009, including discontinued operations, was $(8.4) million, compared to $(4.1) million in the same quarter of the prior year.

Cash and cash equivalents were $4.8 million at the end of the 2009 fourth quarter, down $1.4 million from $6.2 million at the end of the third quarter of 2009. The decrease in cash in the fourth quarter primarily resulted from our operating losses in the period.

Company Background

Prior to our acquisition of Bluehill ID, we were focused on providing security and identity solutions for secure access, secure identity and secure exchange. During the periods covered by this report, we sold our security and identity solutions in two primary market segments: Security and Identity Solutions (formerly called Secure Authentication) and Digital Media and Connectivity.

For the Security and Identity Solutions market, we offer a broad range of contact, contactless and mobile smart card reader technology, access control products and digital identity and transaction platforms, as well as systems that integrate physical access control, secure data storage and transmission, digital certificates, biometrics and digital video. These solutions are sold under the Hirsch Electronics and SCM Microsystems brands. Our Security and Identity solutions are used in a wide variety of industries for security, identity, contactless payment, e-health and electronic government services. We also offer a range of smart card-based productivity solutions, which include readers and software, for small and medium-size businesses under our CHIPDRIVE® brand.

For the Digital Media and Connectivity market, we offer commercial digital media readers that are used in digital photo kiosks to transfer digital content to and from various flash media.

Recent Trends and Strategies for Growth

We have adopted a multi-pronged strategy for growth that includes efforts to expand and diversify our customer base, fully capture emerging market opportunities and accelerate long-term growth.

A major component of our growth strategy is to actively seek merger and acquisition opportunities to expand our business, reinforce our market position in targeted areas and fully leverage our strengths and opportunities to enter new markets. We completed the acquisition of Hirsch during the second quarter of 2009. We believe our acquisition of Hirsch supported our growth strategy, as it increased our revenues by 60%, helped further diversify our customer base and positioned our company to better address the growing market demand for solutions that address both IT security and physical access, a trend referred to in the security industry as convergence. During the third quarter of 2009, we announced our intention to acquire Bluehill ID, a Swiss industrial holding group focused on investments in the RFID/identification and security industries. We completed the acquisition of Bluehill ID on January 4, 2010. We believe our acquisition of Bluehill ID presents a strategic opportunity to strengthen our position in the security industry and is a crucial step to create the signature company for security and identity-based technologies and solutions.

On April 30, 2009, we completed our acquisition of Hirsch, a private California corporation that manufactures and sells physical access control and other security management systems. Following the acquisition, Hirsch became a Delaware limited liability company and wholly-owned subsidiary of the Company. In exchange for all of the outstanding capital stock of Hirsch, we paid approximately $14.2 million in cash, issued approximately 9.4 million shares of our common stock and issued warrants to purchase approximately 4.7 million shares of our common stock as consideration in connection with the Hirsch acquisition. Further details of the acquisition are described in Note 2 to the financial statements included in this Annual Report on Form 10-K. Former Hirsch shareholders beneficially own approximately 37% of the shares of the Company s common stock outstanding. Upon the closing of the acquisition, Lawrence Midland, a former Hirsch director and current President of Hirsch, joined our Board of Directors and became an Executive Vice President of the Company. Douglas Morgan, a former director of Hirsch, also joined the Board of Directors of the Company. As a result of our acquisition of Hirsch, Hirsch s operating results have been included in our consolidated results since the date of acquisition, and will continue to be included in our consolidated results going forward.

On January 4, 2010, we completed our acquisition of Bluehill ID. To effect the transaction, we made an offer to the Bluehill ID shareholders to acquire all of the Bluehill ID shares and issued 0.52 new shares of our common stock for every one share of Bluehill ID tendered. Approximately 29,422,714, or 92% of Bluehill ID shares outstanding were tendered in the offer and exchanged for a total of approximately 15,299,797 new shares of the Company s common stock. As a result of our January 4, 2010 acquisition of Bluehill ID, Bluehill ID s operating results will be included in our consolidated results going forward. Following the close of the transaction, approximately 38% of the Company s outstanding shares are now held by former Bluehill ID shareholders. Prior to the close of the transaction, Werner Koepf, the former Chairman of our Board of Directors, resigned and following the closing of the transaction, Ayman S. Ashour, Chief Executive Officer of Bluehill ID, joined the Board of Directors of the Company and was named Executive Chairman of the Board of Directors. Dr. Cornelius Boersch and Daniel S. Wenzel, both former directors of Bluehill ID, also joined the Board of Directors of the Company. In February 2010, Dr. Boersch resigned from the Board of Directors and on March 1, 2010, Mr. Ashour was appointed Chief Executive Officer and Chairman of the Board and Felix Marx, our Chief Executive Officer, was named Chief Operating Officer of the Company.

Following our acquisition of Bluehill ID, three other executives from Bluehill ID also joined the management team of the Company, including Melvin Denton-Thompson, who was appointed Chief Financial Officer; John S. Rogers, who was appointed Executive Vice President Transition Management and Acquisition Integration; and Joseph Tassone, who was appointed Executive Vice President Technology and Product Management. The new management from Bluehill ID has extensive expertise in identifying acquisition candidates, executing mergers and acquisitions and successfully integrating acquired businesses. We expect that mergers and acquisitions will continue to be a major focus of our growth strategy going forward.

Another component of our strategy is the development of a broad range of new contactless infrastructure products to enable fast growing contactless applications and services for markets such as electronic transactions (including payment and ticketing) and various electronic security programs within the government and enterprise

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sectors. Our contactless readers, modules and tokens are intended to address markets such as national /citizen ID, electronic passports, physical and logical (computer) security and mobile transactions, among others. Additionally, we are developing and implementing programs to market our existing product offerings into new distribution channels and new geographic regions. The worldwide economic downturn has slowed our progress in penetrating new markets; however, we continue to invest in the products, programs and resources to develop new customers.

Trends in our Business

Sales Trends

The global economic downturn and ongoing economic uncertainty created a broader cautionary environment for us and for our customers in 2008 and 2009 and has resulted in decreased or delayed orders for our products across geographic markets. We believe sales to some markets will continue to be constricted until the global economic environment strengthens, end user demand increases and the lending environment for capital purchases improves. Despite the continued sluggishness of security and identity programs during 2009, our revenue increased 46% compared to 2008 as a result of our acquisition of Hirsch and investments made in key markets and regions.

We believe that our acquisition of Hirsch has strengthened our performance across multiple financial metrics, our ability to capture new and existing sales opportunities and our overall business profile. As a result of the inclusion of Hirsch operating results, sales increased 60% in our Security and Identity Solutions business in 2009 compared to 2008, with Hirsch product sales generally having a higher gross profit margin than SCM Microsystems product sales. The integration of Hirsch into the Company was largely completed in the fourth quarter of 2009.

In the U.S. government market, sales of our smart card reader products for PC and network access by military and federal employees historically has been an important component of our overall revenue composition. In addition to normal variability in demand quarter to quarter, in recent periods, project and budget delays in the U.S. government sector and the rapid shift towards lower cost embedded chips rather than external smart card readers by laptop and keyboard manufacturers servicing the U.S. government sector have constricted our sales of SCM branded products in this market. The U.S. government sector is also an important market for our Hirsch business, but Hirsch s sales model is more focused on the provision of integrated systems, rather than point solutions, and is generally less susceptible to variability from project delays and other factors. In the 2009 fourth quarter, sales from the Hirsch business were up 6% compared with the fourth quarter of 2008, and a significant percentage of Hirsch sales related to projects at federal government agencies. We believe that our acquisition of Hirsch has created a more stable and consistent revenue profile for the Company in the U.S. government sector, given Hirsch s sales model. We further believe that Hirsch s ability to offer complete systems and professional services complements and strengthens our competitive position and provides significant new opportunities for incremental revenue growth.

While revenues in Europe generally remained stable, the weak economic environment continued to constrict sales to both established and new customers in 2009. In general, smart-card based security projects in all sectors have continued to experience delays or are limited in scale. At the same time, sales development activities we initiated 12 to 18 months ago as part of our strategy to broaden our market and geographic penetration are resulting in higher customer engagement than in past periods. Previously we had expected that the roll-out of electronic health insurance cards in Germany would provide a significant revenue opportunity for us in 2009 and going forward. However, the German government authorities have continued to delay implementation of this program and this has resulted in little revenue for us in recent months. We continue to be a significant supplier of eHealth terminals for the program as it operates currently and believe that we are well positioned to participate in addressing the need for terminals to read the millions of eHealth cards that were originally intended to be distributed to Germany s citizens under the program. However the amount and timing of any significant sales to support this program is uncertain due to the current lack of support from the German government authorities.

Sales of our smart card reader chips continued to be strong in Asia during 2009. During the year we added new distribution partners and sales resources in Asia to penetrate new geographic markets and applied a more systematic and focused approach to sales in countries such as China, India, Malaysia, the Philippines and Thailand. In Japan, the weak economic environment continued to constrict sales.

Following our acquisition of Bluehill ID and the significant changes this acquisition has made in the organization structure and composition of our business, our sales trends may change significantly. In general, we continue to expect that we may experience significant variations in demand for our products quarter to quarter. This is particularly true for our smart card reader products, a significant portion of which are currently sold for smart card-based ID programs run by various U.S., European and Asian governments. Sales of our smart card readers and chips for government programs are impacted by testing and compliance schedules of government bodies as well as roll-out schedules for application deployments, both of which contribute to variability in demand from quarter to quarter. Further, this business is typically subject to seasonality based on governmental budget cycles, with lowest sales in the first quarter and highest sales in the fourth quarter of each year. Additionally, our dependence on a small number of customers in each of our businesses may in any given period result in additional variability in our revenues.

Gross Profit Margin Trends

Our acquisition of Hirsch has resulted in a favorable impact on our gross profit margin, as Hirsch s sales typically yield margins that are higher than sales of the SCM branded smart card reader products. We expect that our gross profit margin will continue to benefit from this more favorable mix of products going forward, although there may be a small offsetting impact from some of the businesses we acquired from Bluehill. Additionally, we have implemented ongoing cost reduction programs to address pricing pressure in our business and these programs have generally resulted in ongoing improvements to our product margins. We believe we should be able to offset ongoing pricing pressure and material cost increases with continual improvements in our supply chain systems.

Operating Expense Trends

Our operating expenses in 2009 reflect the addition of expenses for the Hirsch business, as well as approximately $4.0 million in transaction costs relating to the merger of Hirsch and the business combination with Bluehill ID and $0.7 million related to severance costs, primarily for our former CFO.

During 2009, we focused the majority of our research and development activities on the development of new SCM branded contactless readers, tokens and modules and on extending our contactless platforms. We also continued our engineering investment to develop Hirsch s next generation of controllers, which we expect will be completed during 2010. Additionally, we invested in custom development for our OEM market and in the development of a range of physical access control projects in both our Hirsch and SCM businesses.

Over the last 12 months, acquisition-related costs have caused a significant increase in general and administrative expenses. This may continue, as pursuing merger and acquisition opportunities is an important component of our growth strategy. Beginning in January 2010 and alongside the integration of the businesses acquired from Bluehill ID, we have implemented a cost reduction program designed to identify areas for significant cost reduction. To date, actions have included the announced closure of an office in Mainz, Germany, the consolidation and streamlining of research and development activities between our existing and newly acquired facilities in India, and the negotiation of more favorable pricing from existing or new suppliers of professional services. Going forward, we will continue to focus on identifying areas for expense reduction, particularly general and administrative.

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Results of Operations

The following table sets forth our statements of operations as a percentage of net revenue for the periods indicated:

	Years Ended December 31, 2009	2008	2007
Net revenue	100.0%	100.0%	100.0%
Cost of revenue	55.2	55.8	58.4
Gross profit	44.8	44.2	41.6
Operating expenses:			
Research and development	12.3	13.8	10.3
Selling and marketing	37.7	33.9	21.7
General and administrative	29.3	28.5	23.4
Amortization of intangibles			0.9
Impairment of intangibles	1.6		
Gain on sale of assets	(3.4)	(5.1)	
Total operating expenses	77.5	71.1	56.3
Loss from operations	(32.7)	(26.9)	(14.7)
Loss and impairment on equity investments	(5.4)	(0.9)	
Interest (expense) income	(1.2)	2.7	5.4
Foreign currency gains (losses), net	0.2	(9.3)	(1.1)
Loss from continuing operations before income taxes	(39.0)	(34.4)	(10.4)
Benefit (provision) for income taxes	3.8	(2.7)	(0.4)
Loss from continuing operations	(35.2)	(37.1)	(10.8)
Gain (loss) from discontinued operations, net of income taxes	0.5	(0.7)	(0.7)
Gain on sale of discontinued operations, net of income taxes	0.4	2.1	5.2
Net loss	(34.3)%	(35.7)%	(6.3)%

Revenue

The following table sets forth our annual revenues and year-to-year change in revenues by product segment for the fiscal years ended December 31, 2009, 2008 and 2007. The comparability of our operating results in 2009 versus prior years is primarily impacted by our acquisition of Hirsch on April 30, 2009. Eight months of operating results from the acquired Hirsch business are included in the 2009 figures.

	Fiscal 2009	% Change 2009 to 2008	Fiscal 2008 (In thousands)	% Change 2008 to 2007	Fiscal 2007
Security and Identity Solutions					
Revenues	$ 38,055	60%	$ 23,711	(3)%	$ 24,427
Percentage of total revenues	92%		84%		80%
Digital Media and Connectivity					
Revenues	$ 3,260	(30)%	$ 4,651	(23)%	$ 6,008
Percentage of total revenues	8%		16%		20%

Total revenues	$ 41,315	46%	$ 28,362	(7)%	$ 30,435

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Fiscal 2009 Revenue Compared with Fiscal 2008 Revenue

Revenue for the year ended December 31, 2009 was $41.3 million, up 46% from $28.4 million in 2008. The increase in 2009 revenue compared with the prior year was the result of incremental revenues from the Hirsch business, which was acquired in the second quarter of 2009. Excluding Hirsch, revenue in our Security and Identity Solutions segment decreased 14% in 2009 from the previous year. Revenue from our Digital Media and Connectivity products also decreased 30% in 2009 compared with 2008. Sales of our Security and Identity Solutions products accounted for 92% of total revenue and sales of Digital Media and Connectivity products accounted for 8% of revenue in 2009.

Following our acquisition of Hirsch, revenue in our Security and Identity Solutions business during 2009 principally consisted of sales of smart card readers, related chip technology and access control products that are primarily used in security programs where smart cards and/or personal identification (PIN) codes are employed to authenticate the identity of people in order to control access to computers or computer networks; borders; buildings and other facilities; and services, such as health care. Additionally, this business includes sales of digital identity and transaction platforms, as well as systems that integrate physical access control, secure data storage and transmission, digital certificates, biometrics and digital video. Also included in this business segment are our CHIPDRIVE software and reader solutions, which provide electronic timecard and other productivity applications for small and medium enterprises and are primarily sold in Europe. The majority of revenue in our Security and Identity Solutions business segment is related to government, financial or enterprise programs and is subject to variability based on the size and timing of customer orders.

Revenue in our Security and Identity Solutions business was $38.1 million in 2009, up 61% from $23.7 million in 2008. This increase was due to the inclusion of incremental revenues from the acquired Hirsch business, beginning in the second quarter of 2009. Hirsch sales in 2009 were up slightly year over year, driven by orders for products, systems and services for U.S. government agency deployments. European and Asian sales of SCM branded smart card reader products remained relatively unchanged in 2009 compared with the prior year, while sales of SCM branded smart card reader products in the U.S. were down approximately 38%. The decrease in sales of SCM branded smart card reader products in the U.S. was primarily the result of acceleration in the trend towards embedded chips, which are sold out of Asia, rather than smart card readers, which are sold out of the U.S. In addition, variability in the timing of orders continues to be a factor in this business. Sales in Asia continued to reflect strong demand for embedded smart card reader chips. Sales in Europe were characterized by variability in the timing of orders during 2009, however overall demand remained stable. At the same time, European sales of our CHIPDRIVE business productivity products aimed at small and medium enterprises continued to be depressed as a result of the weak economic environment. Additionally, although we continued to be a significant supplier of eHealth terminals Germany s electronic healthcard rollout, sales were significantly lower than expected due to slower than anticipated implementation by the German government authorities.

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

Revenue in our Digital Media and Connectivity business was $3.3 million in 2009, a decrease of 30% from $4.7 million in 2008, primarily as a result of reduced consumer usage of photo kiosks and reduced roll-outs of new photo kiosks by our customers due to the economic downturn and competition with on-line photo finishing sites.

Fiscal 2008 Revenue Compared with Fiscal 2007 Revenue

Revenue for the year ended December 31, 2008 was $28.4 million, a decrease of 7% from $30.4 million in 2007. This decrease was due primarily to a 23% decline in sales of our Digital Media and Connectivity products, as well as, to a lesser extent, a 3% decrease in sales of our Security and Identity Solutions products. Sales of our Security and Identity Solutions products accounted for 84% of total revenue and sales of Digital Media and Connectivity products accounted for 16% of revenue in 2008.

Security and Identity Solutions product revenue was $23.7 million in 2008, a decrease of 3% from $24.4 million in 2007. Our Security and Identity Solutions product line principally consists of smart card readers and related chip technology that are primarily used in large security programs where smart cards are employed to authenticate the identity of people in order to control access to computers or computer networks; borders; buildings and other facilities; and services, such as health care. Also included in this business segment are our CHIPDRIVE software and reader solutions, which provide electronic timecard and other productivity applications for small and medium enterprises, and are primarily sold in Europe. The majority of revenue in our Security and Identity Solutions business segment is related to government, financial or enterprise programs and is subject to significant variability based on the size and timing of customer orders.

The decrease in Security and Identity Solutions product sales in 2008 compared with the prior year was primarily due to a significant reduction in sales of our smart card reader products for U.S. government authentication programs in the first two quarters of 2008, mainly due to project and budget delays. During 2008, we have also experienced an ongoing shift in the U.S. government market away from external reader devices and towards interface chips that provide embedded reader technology in laptops and keyboards. We have sold high volumes of smart card interface chips for embedded readers to laptop and keyboard manufacturers in Asia that have somewhat offset the decrease in sales of our external reader devices in the U.S.; however, these chips have a lower average selling price than our external reader devices.

The largest percentage of Security and Identity Solutions product revenues in 2008 came equally from sales of readers for U.S. government projects to comply with Homeland Security Presidential Directive-12 and other federal mandates, and sales of readers for electronic identification and other programs in Europe. Sales of smart card interface chips in Asia demonstrated the fastest rate of growth in 2008 of any of our products. Sales of our CHIPDRIVE business productivity solutions were relatively flat year to year.

Revenue from our Digital Media and Connectivity product line was $4.7 million in 2008, a decrease of 23% from $6.0 million in 2007. Our Digital Media and Connectivity product line consists of digital media readers and related ASIC technology used to provide an interface for flash memory cards, primarily embedded in digital photography kiosks, where the readers are used to download and print digital photos. Two to three customers, historically, have accounted for approximately two-thirds of sales in this business segment. As a result, revenue in our Digital Media and Connectivity product line can fluctuate significantly quarter to quarter due to variability in the size and timing of customer orders. The revenue decrease in 2008 was primarily due to reduced orders from a major customer in the second half of 2008.

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Gross Profit

The following table sets forth our gross profit and year-to-year change in gross profit by product segment for the fiscal years ended December 31, 2009, 2008 and 2007. The comparability of our operating results in 2009 versus prior years is primarily impacted by our acquisition of Hirsch on April 30, 2009. Eight months of operating results from the acquired Hirsch business are included in the 2009 figures.

	Fiscal 2009	% Change 2009 to 2008	Fiscal 2008 (In thousands)	% Change 2008 to 2007	Fiscal 2007
Security and Identity Solutions					
Revenues	$ 38,055		$ 23,711		$ 24,427
Gross profit	17,430	60%	10,910	4%	10,472
Gross profit %	46%		46%		43%
Digital Media and Connectivity					
Revenues	$ 3,260		$ 4,651		$ 6,008
Gross profit	1,081	(34)%	1,635	(25)%	2,182
Gross profit %	33%		35%		36%
Total:					
Revenues	$ 41,315		$ 28,362		$ 30,435
Gross profit	18,511	48%	12,545	(1)%	12,654
Gross profit %	45%		44%		42%

Gross profit for 2009 was $18.5 million, or 45% of revenue. During 2009, gross profit was positively impacted by the inclusion of sales of higher-margin Hirsch products in the second, third and fourth quarters, offset by a $0.8 million write-off to inventory in the fourth quarter of 2009 related to terminals for the stalled German eHealth program. By product segment, gross profit for our Security and Identity Solutions products was 46% and gross profit for our Digital Media and Connectivity products was 33% in 2009.

Gross profit for 2008 was $12.5 million, or 44% of revenue. During 2008, gross profit was impacted by a more favorable mix of higher margin products overall and product cost reductions in our Security and Identity Solutions business, offset by lower Digital Media and Connectivity product volumes. By product segment, gross profit for our Security and Identity Solutions products was 46% and gross profit for our Digital Media and Connectivity products was 35% in 2008.

Gross profit for 2007 was $12.7 million, or 42% of revenue. During 2007, gross profit was impacted by a favorable mix of products sold, including our CHIPDRIVE products, better inventory management and product cost reductions, particularly in our Security and Identity Solutions business. Offsetting these positive factors were low sales levels of Digital Media and Connectivity products in the first half of the year and low sales levels of Security and Identity Solutions products in the second quarter of 2007, as well as pricing pressure over the last several quarters. By product segment, gross profit for our Security and Identity Solutions products was 43% and gross profit for our Digital Media and Connectivity products was 36% in 2007.

We expect there will be some variation in our gross profit from period to period, as our gross profit has been and will continue to be affected by a variety of factors, including, without limitation, competition, the volume of sales in any given quarter, product configuration and mix, the availability of new products, product enhancements, software and services, inventory write-downs and the cost and availability of components.

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Operating Expenses

Research and Development

	Fiscal 2009	% Change 2009 to 2008	Fiscal 2008 (In thousands)	% Change 2008 to 2007	Fiscal 2007
Expenses	$ 5,062	30%	$ 3,902	25%	$ 3,123
Percentage of revenue	12%		14%		10%

Research and development expenses consist primarily of employee compensation and fees for the development of hardware, software and firmware products. We focus the bulk of our research and development activities on the development of products for new and emerging market opportunities. Figures for 2009 include eight months of expenses from our acquired Hirsch business.

Research and development expenses were $5.1 million in 2009, up 30% from $3.9 million in 2008, primarily as a result of the inclusion of additional expenses related to the Hirsch business. Excluding Hirsch expenses, research and development expenses decreased 15% in 2009 compared with 2008. This decrease was the result of reduced development activity in 2009 following a significant increase in activity in 2008 to develop eHealth terminals and new contactless product platforms, which work was substantially completed by the end of 2008. During 2009, we continued to focus on the development of contactless readers, token and modules for the SCM smart card reader business and a new generation of advanced controllers for the Hirsch business.

Research and development expenses were $3.9 million in 2008, up 25% from $3.1 million in 2007. The increase in research and development expenses in 2008 was primarily due to the development of new contactless Security and Identity Solutions products and increased development activity related to card terminals for the German e-healthcard program. In 2007, we focused primarily on the development of smart card reader technology for the German e-healthcard program, electronic ID applications and the global e-passport market.

We expect our research and development expenses to vary based on future project demands and the markets we target. We expect that research and development expenses will increase in 2010 based on the inclusion of additional expenses from the businesses acquired in the Bluehill ID transaction. As a result of the acquisition of Bluehill ID, we now have two development centers located in Chennai, India. As announced and as filed with the SEC on a current report on Form 8-K on February 3, 2010, we intend to combine and streamline these two operations in order to lower overhead costs.

Selling and Marketing

	Fiscal 2009	% Change 2009 to 2008	Fiscal 2008 (In thousands)	% Change 2008 to 2007	Fiscal 2007
Expenses	$ 15,584	62%	$ 9,620	46%	$ 6,603
Percentage of revenue	38%		34%		22%

Selling and marketing expenses consist primarily of employee compensation as well as tradeshow participation, advertising and other marketing and selling costs. We focus a significant proportion of our sales and marketing activities on new and emerging market opportunities. Figures for 2009 include eight months of expenses related to our acquired Hirsch business.

Sales and marketing expenses were $15.6 million in 2009, up 62% from $9.6 million in 2008, primarily due to the inclusion of additional expenses related to the Hirsch business. Also included in 2009 are approximately $0.1 million in severance costs. During 2008 we increased investment to build up sales resources and create business development programs both in our traditional markets and also in the contactless market, particularly in Asia and Latin America, and these new resources and programs were substantially in place by the end of 2008. As a result, excluding Hirsch expenses, sales and marketing expenses decreased 14% in 2009 compared with 2008.

Sales and marketing expenses were $9.6 million in 2008, up 46% from $6.6 million in 2007. The increase in sales and marketing expenses in 2008 was primarily due to the hiring of new sales resources during the year in Asia, Europe and the Americas to enhance our ability to address current and future business opportunities, as well as an increased level of marketing programs and travel expenses related to new business development activities. Also included in 2008 are approximately $0.3 million in severance costs.

We expect that sales and marketing expenses will increase in 2010 based on the inclusion of additional expenses from the businesses acquired in the Bluehill ID transaction.

General and Administrative

	Fiscal 2009	% Change 2009 to 2008	Fiscal 2008 (In thousands)	% Change 2008 to 2007	Fiscal 2007
Expenses	$ 12,091	50%	$ 8,075	13%	$ 7,128
Percentage of revenue	29%		28%		23%

General and administrative expenses consist primarily of compensation expenses for employees performing administrative functions, and professional fees arising from legal, auditing and other consulting services. Figures for 2009 include eight months of expenses related to our acquired Hirsch business.

General and administrative expenses in 2009 were $12.1 million, up 50% from $8.1 million in 2008, primarily due to one-time transaction and severance costs, as well as the inclusion of additional expenses from the acquired Hirsch business. Transaction related costs in 2009 were $4.0 million and related to the merger with Hirsch and the business combination with Bluehill ID. Severance costs were $0.6 million and primarily related to payments made to our former chief financial officer in the 2009 third quarter. Excluding Hirsch expenses, the one-time expenses described above and one-time transaction expenses of $1.4 million in 2008, general and administrative expenses decreased 5% in 2009 compared with the prior year as a result of close management of spending and reductions in non-critical areas.

General and administrative expenses in 2008 were $8.1 million, up 13% from $7.1 million in 2007. Higher general and administrative expenses in 2008 primarily resulted from increased business development activities related to our strategy to expand and diversify our customer base and market opportunities. Additionally, the fourth quarter of 2008 included $1.4 million of legal, consulting, auditing and other expenses related to our proposed merger with Hirsch, as well as $0.1 million in severance costs. General and administrative expenses in 2008 were also impacted by the devaluation of the dollar in the first half of the year against foreign currencies, namely the euro, as we pay the majority of these expenses in local currency but account for those expenses in dollars.

General and administrative expenses in 2007 also included $1.4 million in severance and other costs related to our former CEO.

We expect that general and administrative expenses will increase in 2010 based on the inclusion of additional expenses from the businesses acquired in the Bluehill ID transaction.

Amortization and Impairment of Intangibles

Amortization and impairment of intangible assets was $0.6 million in 2009, zero in 2008 and $0.3 million in 2007. Amortization and impairment of intangible assets in 2009 was related to an impairment charge related to the write-off of exclusivity fees paid to TranZfinity. (See Note 8 for further detail about Intangible Assets TranZfinity.)

Gain on Sale of Assets

During 2009, we recorded $1.4 million gain on the sale of assets, which included a gain of $1.2 million on the sale of our office building in India and a gain of $0.2 million on the sale of certain non-core patents that were unrelated to our current business.

During 2008, we recorded $1.4 million gain on the sale of certain non-core patents that were unrelated to our current business. A further $0.1 million gain was realized on the sale of unused land.

Loss and Impairment on Equity Investments

During 2009, we recorded a loss on equity investments of $2.2 million, which related to the impairment of our equity method investment in TranZfinity and our proportionate share of losses realized by TranZfinity. We made the determination that our investment in TranZfinity was impaired during the fourth quarter of 2009, based on our assessment of TranZfinity s performance and future prospects. Subsequent to year-end, TranZfinity management and shareholders concluded that TranZfinity business is no longer viable and decided to dissolve the TranZfinity s operations. See Note 6 for further detail about the TranZfinity investment.

During 2008, we recorded a loss on equity investments of $0.3 million, $0.2 million of which related to our share of the losses of our equity method investment in TranZfinity and $0.1 million of which related to amortization of the difference between our cost and underlying equity in net assets of TranZfinity, subsequent to the date of investment.

Interest (Expense) Income

Interest (expense) income consists of interest accretion expense for a liability to related party in the Hirsch business, offset by interest earned on invested cash.

We had interest expense of $(0.5) million in 2009, compared with interest income of $0.8 million in 2008 and interest income of $1.6 million in 2007. The $(0.5) million of interest expense recorded in 2009 resulted from an ongoing liability to a related party related to the Hirsch business (further described in Note 16), with no offsetting interest income, as invested cash balances were lower in 2009.

The reduction in interest income in 2008 compared with 2007 resulted from a reduced cash balance and the reduction in interest rates in 2008 compared to the prior year.

Foreign Currency Gains (Losses)

We recorded foreign currency exchange gains of $0.1 million in 2009, compared with foreign exchange losses of $2.6 million in 2008 and $0.3 million in 2007. Changes in currency valuation in all periods presented were primarily a result of exchange rate movements between the U.S. dollar and the euro and the British pound.

Our foreign currency losses primarily result from the valuation of current assets and liabilities denominated in a currency other than the functional currency of the respective entity in the local financial statements. Accordingly, these foreign currency losses are predominantly non-cash items.

Higher foreign exchange losses in 2008 were primarily the result of the weakening of the euro and the British pound versus the U.S. dollar during the second half of the year and the impact of these currency fluctuations on our accounting for intercompany balances. To reduce our exposure to fluctuations in foreign exchange valuations, we have settled the significant intercompany balances that previously had contributed to foreign exchange gains and losses.

For 2007, foreign currency losses were $0.3 million and no other income was recorded.

Income Taxes

In 2009, we recorded an income tax benefit of $1.5 million while in 2008 and 2007 we recorded provisions for income taxes of $0.8 million and $0.1 million, respectively.

The income tax benefit in 2009 resulted from an income tax benefit of $1.7 million related to the Hirsch acquisition; $0.4 million of income tax expense related to foreign subsidiaries with no loss carryforwards; a $0.3 million benefit for the true-up of prior year taxes; and an expense of $0.1 million related to state taxes which could not be offset by net operating loss carryovers.

Income tax expense in the 2008 period resulted from $0.4 million related to deferred tax liabilities for undistributed earnings and profits of the Company s subsidiaries, which are not considered to be permanently invested; $0.3 million income tax expense related to a foreign subsidiary with no loss carryforwards; and $0.1 million primarily for minimum taxation, which could not be offset with operating loss carryforwards. Income tax expense in 2007 was primarily for minimum taxation, which could not be offset with operating loss carryforwards and tax expenses in a foreign subsidiary with no loss carryforwards.

Discontinued Operations

On May 22, 2006, we completed the sale of substantially all the assets and some of the liabilities associated with our DTV solutions business to Kudelski S.A. Revenue for the DTV solutions business was zero in 2009 and 2008 and $0.5 million in 2007. Operating gain (loss) for the DTV solutions business was $132,000, $2,000 and $0.1 million in 2009, 2008 and 2007, respectively. Net gain (loss) for the DTV solutions business was $147,000, $2,000 and $0.1 million in 2009, 2008 and 2007, 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.

We recorded no revenue for the retail Digital Media and Video business in 2009, 2008 or 2007. Operating loss for the retail Digital Media and Video business was $0.3 million in each of the same periods. Net gain (loss) for the retail Digital Media and Video business was $79,000, $(0.2) million and $(0.3) million for 2009, 2008 and 2007 respectively.

During 2009, we recorded a net gain on disposal of discontinued operations of $0.2 million, primarily related to changes in estimates for lease commitments.

During 2008, we recorded a net gain on disposal of discontinued operations of $0.6 million, including $0.2 million related to changes in estimates, related to the termination of our lease agreement for premises leased in the UK.

During 2007, we recorded a net gain on disposal of discontinued operations of $1.6 million, primarily related to the final payment received for the sale of the assets of the DTV solutions business.

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Liquidity and Capital Resources

As of December 31, 2009, our working capital, which we define as current assets less current liabilities, was $4.1 million, compared to $23.9 million as of December 31, 2008, a decrease of approximately $19.8 million. The reduction in working capital primarily reflects a cash payment for the Hirsch acquisition of $14.2 million, which was partially offset by an acquired cash balance from the acquisition of $3.3 million. The further reduction in cash and cash equivalents primarily resulted from operating activities. For the twelve months ended December 31, 2009, current assets (excluding cash and cash equivalents) decreased by $0.8 million and current liabilities increased by $3.3 million, also primarily as a result of including the assets and liabilities acquired in the Hirsch transaction.

The following summarizes our cash flows for the twelve months ended December 31, 2009 (in thousands):

	12 Months Ended December 31, 2009
Cash used in operating activities from continuing operations	$ (5,670)
Cash used by operating activities from discontinued operations	(258)
Cash used in investing activities	(9,533)
Effect of exchange rate changes on cash and cash equivalents	(253)
Decrease in cash and cash equivalents	(15,714)
Cash and cash equivalents at beginning of period	20,550
Cash and cash equivalents at end of period	$ 4,836

During 2009, cash used in operating activities was $5.7 million. The net loss of $14.2 million, the non-cash impact from changes in deferred income taxes of $2.1 million and the gain on disposal of property and equipment of $1.4 million was partly offset by the non-cash impact of the loss on equity investments of $2.2 million and cash provided from net changes in operating assets and liabilities of approximately $7.5 million.

Current assets decreased by $16.5 million, resulting from a reduction in cash and cash equivalents of $15.7 million and a reduction in accounts receivable of $1.9 million, partly offset by an increase in other current assets of $0.5 million, an increase in inventories of $0.3 million and an increase in income taxes receivable of $0.3 million. Current liabilities increased by $3.3 million, primarily resulting from higher accounts payable of $2.0 million, and an increase in liability to related parties of $1.0 million, partly offset by an increase in accruals of $0.5 million and lower income taxes payable of $0.2 million.

Significant commitments that will require the use of cash in future periods include obligations under operating leases, inventory purchase commitments and other contractual agreements. Gross committed lease obligations were approximately $4.3 million at December 31, 2009. Inventory and other purchase commitments due within one year were approximately $8.6 million, and additional purchase and contractual commitments due within two years were approximately $1.9 million at December 31, 2009.

The cash used in investing activities primarily reflects the cash payment for the Hirsch acquisition of $14.2 million and capital expenditures of $0.7 million, offset by an acquired cash balance of $3.3 million from the acquisition and $2.1 million from the net proceeds from sale of assets, primarily for the sale of our office building in India.

Our liquidity plans are subject to a number of risks and uncertainties, including those described in the section Risk Factors, some of which are outside our control. As with many companies across various industries, our liquidity position and our operating performance were negatively affected by the global economic downturn and by other financial and business factors, many of which are beyond our control.

Over the past several quarters we also initiated various activities to preserve cash or generate additional cash. For example in the fourth quarter of 2008 we began selling certain non-strategic patents that are unrelated to our current business, which to date have generated $1.6 million in cash. During the third quarter of 2009, we sold our office building in Chennai, India and recorded a pre-tax gain of $1.2 million.

We currently expect that our current capital resources should be sufficient to meet our operating and capital requirements at least through the end of 2010. 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.

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 U.S. GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, including those related to product returns, customer incentives, bad debts, inventories, asset impairment, deferred tax assets, accrued warranty reserves, restructuring costs, contingencies and litigation. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

We derive revenue from sales of products and services, primarily from sales of hardware products, and to a lesser extent, from the license of proprietary software products and sales of service contracts. We recognize revenue from the sale of hardware products pursuant to ASC Topic 605, *Revenue Recognition* (ASC 605). Accordingly, revenue from product sales is recognized upon product shipment, provided that risk and title have transferred, a purchase order has been received, the sales price is fixed and determinable and collection of the resulting receivable is probable. There are no formal customer acceptance terms or further obligations, outside of Company s standard product warranty, related to the sale of hardware products. Provisions for estimated warranty repairs and returns and allowances are provided for at the time of sale. Certain sales of the Company s hardware products are bundled with its software products. In such arrangements, both the software and hardware products are delivered simultaneously. The Company accounts for software in accordance with ASC Topic 985-605, *Software Revenue Recognition* (ASC 985-605) whereby the revenue from the sale of software products is recognized at the time the software is delivered to the customer, provided all the revenue recognition criteria noted above have been met. All proprietary application software sold by the Company is not essential to the functionality of the security hardware. Therefore, in multiple-element arrangements containing hardware and software, the hardware elements are excluded from ASC 985-605 and are accounted for in accordance with ASC 605-25, *Multiple Element Arrangements*. Revenue from such bundled arrangements is generally recognized upon delivery of the hardware products, assuming all other basic revenue recognition criteria are met, as both the hardware and software products are considered delivered elements and no undelivered elements exist.

Service revenue includes revenue from professional services and maintenance contracts. Typically professional services and maintenance contracts are sold separately from the hardware sales. Professional service revenue, such as, security system integration services, system migration and database conversion services are recognized upon delivery of the services. If the professional service project includes independent milestones, revenue is recognized as milestones are met and upon acceptance from the customer. Maintenance revenue is generated from the sale of hardware maintenance contracts. Maintenance revenue is deferred and amortized ratably over the period of the maintenance contract.

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We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. We regularly review inventory quantities on hand and record an estimated provision for excess inventory, technical obsolescence and inability to sell 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. Once we have written down inventory below cost, we do not subsequently write it up.

In accordance with ASC Topic 740, *Income Taxes* (ASC 740), 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. ASC 740 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. 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.

Resulting from the acquisition of Hirsch, we have recognized goodwill of $21.9 million. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. Goodwill is not subject to amortization but is subject to annual assessment, at a minimum, for impairment in accordance with ASC Topic 350 *Intangibles Goodwill and Other* (ASC 350). We evaluate goodwill, at a minimum, on an annual basis and whenever events and changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit s carrying value, including goodwill, to the fair value of the reporting unit. The fair values of the reporting units are estimated using a combination of quoted market prices, the income, or discounted cash flows, approach and the market approach, which utilizes comparable companies data. If the carrying value of the reporting unit exceeds the fair value, goodwill is considered impaired and a second step is performed to measure the amount of the impairment loss, if any. As discussed in Note 8, the Company performed its annual impairment analysis as of December 1, 2009 and determined that there was no impairment existed at that time.

We evaluate our long-lived assets and certain identifiable intangibles for impairment in accordance with ASC Topic 360, *Property, Plant and Equipment* (ASC 360) whenever events or changes in circumstances indicate that the carrying amount of such assets or intangibles may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by an asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Intangible assets with definite lives are being amortized using the straight-line method over the estimated useful lives of the related assets. For intangible assets, where we have determined that these have an indefinite useful life, no amortization is recognized until its useful life is determined to be no longer indefinite. We evaluate indefinite useful life intangible assets for impairment at a minimum on an annual basis and whenever events and changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

We recognize stock-based compensation expense for all share-based payment awards granted after December 31, 2005, and granted prior to but not yet vest as of December 31, 2005, in accordance with FASB ASC Topic 718, *Compensation Stock Compensation* (ASC 718). Subsequent to December 31, 2005, compensation expense for expected-to-vest stock-based awards is valued under the single-option approach and amortized on a straight-line basis, net of estimated forfeitures. We utilize the Black-Scholes-Merton (BSM) option-pricing model in order to determine the fair value of stock-based awards. The BSM model requires various highly subjective assumptions including volatility, expected option life, and risk-free interest rate. The assumptions used in calculating the fair value of share-based payment awards represent management s best estimates. These estimates involve inherent uncertainties and the application of management s judgment. If factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and recognize expense only for those expected-to-vest shares. If our actual forfeiture rate is materially different from our estimate, our recorded stock-based compensation expense could be different.

Recent Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-14, *Software (Topic 985) Certain Arrangements That Contain Software Elements a consensus of the FASB Emerging Issues Task Force* (EITF) (ASU 2009-14), which amends the scope of software revenue guidance in ASC Subtopic 985-605, *Software-Revenue Recognition,* to exclude tangible products containing software and non-software components that function together to deliver the product s essential functionality.

In October 2009, FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements a consensus of the FASB EITF* (ASU 2009-13), which eliminates the residual method of allocation and requires the relative selling price method when allocating deliverables of a multiple-deliverable revenue arrangement. ASU 2009-13 specifies the best estimate of a selling price is consistent with that used to determine the price to sell the deliverable on a standalone basis.

ASU 2009-14 and ASU 2009-13 are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, and must be adopted in the same period using the same transition method. If adoption is elected in a period other than the beginning of a fiscal year, the amendments in these standards must be applied retrospectively to the beginning of the fiscal year. Full retrospective application of these amendments to prior fiscal years is optional. The Company is currently assessing the timing of adoption and affects that ASU 2009-14 and ASU 2009-13 will have on its consolidated results of operations and financial condition.

The Company adopted ASC Topic 820, *Fair Value Measurements and Disclosures* (ASC 820), as it relates to nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on at least an annual basis, on January 1, 2009 and adopted ASC 820, as it relates to all financial assets and financial liabilities and for all non-financial assets and non-financial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis (i.e., at least annually), on January 1, 2008. ASC 820 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. ASC 820 does not change the accounting for those instruments that were, under previous GAAP, accounted for at cost or contract value. The adoption of ASC 820 did not have a significant impact on the Company s consolidated financial statements.

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In August 2009, the FASB issued ASU No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value* (ASU 2009-05). ASU 2009-05 amends FASB ASC Topic 820 and provides amendments to FASB ASC Subtopic 820-10, *Fair Value Measurements and Disclosures Overall*, for the fair value measurement of liabilities. ASU 2009-05 provides clarification that in circumstances in which a quoted price in an active market for an identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques: (1) a valuation technique that uses: (a) quoted price of the identical liability when traded as an asset, or (b) quoted prices for similar liabilities or similar liabilities when traded as assets, or (2) another valuation technique that is consistent with the principles of FASB ASC Topic 820. The guidance in ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance. The Company s adoption of ASU 2009-5 in the fourth quarter of 2009 did not materially affect the Company s consolidated results of operations or financial condition.

In January 2010, the FASB issued ASU 2010-06 Topic 820, *Improving Disclosures About Fair Value Measurements*, that require additional fair value disclosures. ASU 2010-06 require disclosures about inputs and valuation techniques used to measure fair value as well as disclosures about significant transfers into and out of Levels 1 and 2, beginning in the first quarter of 2010. Additionally, this ASU require presentation of disaggregated activity within the reconciliation for fair value measurements using significant unobservable inputs (Level 3), beginning in the first quarter of 2011. We do not expect that ASU 2010-06 would significantly impact our consolidated financial statements.

In June 2009, the FASB issued ASU No. 2009-01, Topic 105 *Generally Accepted Accounting Principles amendments based upon Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement 162* (ASU 2009-01). ASU 2009-01 adopts Statement of Financial Accounting Standards (SFAS) No. 168 and establishes the FASB Accounting Standards Codification (Codification) as the single source of authoritative accounting principles to be applied to financial statements of nongovernmental entities in conformity with U.S. GAAP. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. The FASB will no longer issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts; instead the FASB will issue Accounting Standards Updates. Accounting Standards Updates will not be authoritative in their own right as they will only serve to update the Codification. The issuance of SFAS 168 and the Codification does not change GAAP. The Company adopted the provisions of ASU 2009-01 for its financial statements issued for the third quarter of 2009 and determined that ASU 2009-01 did not affect its consolidated results of operations or financial condition.

On January 1, 2009, the Company adopted ASC Topic 805, *Business Combinations* (ASC 805). ASC 805 changes the Company s accounting treatment for business combinations on a prospective basis. Under ASC 805, an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred, restructuring costs generally be expensed in periods subsequent to the acquisition date, and changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be included in income tax expense. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. The Company accounted for the acquisition of Hirsch using the provisions of ASC 805.

On January 1, 2009, the Company adopted ASC Topic 810, *Consolidation* (ASC 810). ASC 810 changes the accounting and reporting for minority interests, which will be re-characterized as non-controlling interests and classified as a component of equity. ASC 810 is effective for the Company on a prospective basis for business combinations with an acquisition date beginning in the first quarter of fiscal year 2009. As of December 31, 2009, the Company did not have any non-controlling interests.

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Off-Balance Sheet Arrangements

We have not entered into off-balance sheet arrangements, or issued guarantees to third parties.

Contractual Obligations

The following summarizes expected cash requirements for contractual obligations as of December 31, 2009 (in thousands):

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Operating leases	$ 4,312	$ 1,843	$ 2,074	$ 395	$
Purchase commitments	10,503	8,606	1,897		
Total obligations	$ 14,815	$ 10,449	$ 3,971	$ 395	$

Purchases for inventories are highly dependent upon forecasts of customer demand. Due to the uncertainty in demand from our customers, we may have to change, reschedule, or cancel purchases or purchase orders from our suppliers. These changes may lead to vendor cancellation charges on these purchases or contractual commitments. See Note 15 Commitments for more information about the contractual obligations listed in the table above.

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ITEM 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*

Foreign Currencies

We transact business in various foreign currencies, and accordingly, we are subject to exposure from adverse movements in foreign currency exchange rates. This exposure is primarily related to local currency denominated sales and operating expenses in Europe, India and Japan, where we conduct business in both local currencies and U.S. dollars. We assess the need to utilize financial instruments to hedge foreign currency exposure on an ongoing basis.

Our foreign currency exchange gains and losses are primarily the result of the revaluation of intercompany receivables/payables (denominated in U.S. dollars) and trade receivables (denominated in a currency other than the functional currency) to the functional currency of the subsidiary. We have performed sensitivity analyses as of December 31, 2009 and 2008 using a modeling technique that evaluated the hypothetical impact of a 10% movement in the value of the U.S. dollar compared to the functional currency of the subsidiary, with all other variables held constant, to determine the incremental transaction gains or losses that would have been incurred. The foreign exchange rates used were based on market rates in effect at each of December 31, 2009 and 2008. The results of this hypothetical sensitivity analysis indicated that a hypothetical 10% movement in foreign currency exchange rates would result in increased foreign currency gains or losses of $1.3 million and $0.8 million for 2009 and 2008, respectively.

Fixed Income Investments

We do not use derivative financial instruments in our investment portfolio. We do, however, limit our exposure to interest rate and credit risk by establishing and strictly monitoring clear policies and guidelines for our fixed income portfolios. At the present time, the maximum duration of any investment in our portfolio is limited to less than one year. The guidelines also establish credit quality standards, limits on exposure to one issue or issuer, as well as to the type of instrument. Due to the limited duration and credit risk criteria we have established, our exposure to market and credit risk is not expected to be material.

At December 31, 2009, we had $4.8 million in cash and cash equivalents and no short-term investments. Based on our cash and cash equivalents as of December 31, 2009, a hypothetical 10% change in interest rates along the entire interest rate yield curve would not be expected to materially affect the fair value of our financial instruments that are exposed to changes in interest rates.

At December 31, 2008, we had $20.6 million in cash and cash equivalents and no short-term investments. Based on our cash and cash equivalents as of December 31, 2008, a hypothetical 10% change in interest rates along the entire interest rate yield curve would not be expected to materially affect the fair value of our financial instruments that are exposed to changes in interest rates.

ITEM 8. ***FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA***
Index to Consolidated Financial Statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

of SCM Microsystems, Inc.:

We have audited the accompanying consolidated balance sheets of SCM Microsystems, Inc. and subsidiaries (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2009. Our audits also included the financial statement schedule listed at Item 15(a)(2) of this Annual Report on Form 10-K. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of SCM Microsystems, Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ **DELOITTE & TOUCHE GMBH**
WIRTSCHAFTSPRÜFUNGSGESELLSCHAFT

Munich, Germany
March 08, 2010

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SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands; except par value)	**December 31, 2009**	**2008**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,836	$ 20,550
Accounts receivable, net of allowances of $866 and $689 as of December 31, 2009 and 2008, respectively	6,739	8,665
Inventories, net	5,379	5,065
Income taxes receivable	274	
Other current assets	1,647	1,139
Total current assets	18,875	35,419
Equity investments		2,244
Property and equipment, net	683	1,236
Goodwill	21,895	
Intangible assets, net	22,082	307
Other assets	1,036	1,932
Total assets	$ 64,571	$ 41,138
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,530	$ 3,555
Liability to related parties	1,027	
Accrued compensation and related benefits	2,884	1,763
Accrued restructuring and other charges	1,022	1,576
Accrued professional fees	1,321	1,419
Other accrued expenses	2,789	2,764
Income taxes payable	188	411
Total current liabilities	14,761	11,488
Long-term liability to related party	7,899	
Deferred tax liability	3,515	1,340
Long-term income taxes payable	456	184
Total liabilities	26,631	13,012
Commitments and contingencies (see Notes 15 and 17)		
Stockholders equity:		
Common stock, $0.001 par value: 60,000 shares authorized; 25,753 and 16,362 shares issued and 25,135 and 15,744 shares outstanding as of December 31, 2009 and 2008, respectively	26	16
Additional paid-in capital	253,910	229,788
Treasury stock, 618 shares	(2,777)	(2,777)
Accumulated deficit	(216,378)	(202,199)
Accumulated other comprehensive income	3,159	3,298