SCM MICROSYSTEMS INC
Form 10-Q
August 12, 2008

Table of Contents

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

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM _________ TO _________
COMMISSION FILE NUMBER: 0-29440

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

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

Oskar-Messter-Str. 13, 85737 Ismaning, Germany
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES INCLUDING ZIP CODE)
+ 49 89 95 95 5000
(REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE)
(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o	Smaller reporting company þ
		(Do not check if a smaller reporting company)	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ
At August 5, 2008, 15,743,515 shares of common stock were outstanding.

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

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

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Net revenue	$ 6,520	$ 4,647	$ 12,984	$ 13,104
Cost of revenue	3,697	3,314	7,478	8,031
Gross profit	2,823	1,333	5,506	5,073
Operating expenses:				
Research and development	1,043	792	2,078	1,512
Selling and marketing	2,569	1,618	4,730	3,177
General and administrative	1,518	2,879	3,021	4,279
Amortization of intangible assets	0	97	0	272
Total operating expenses	5,130	5,386	9,829	9,240
Loss from operations	(2,307)	(4,053)	(4,323)	(4,167)
Interest and other income, net	330	412	824	720
Loss from continuing operations before income taxes	(1,977)	(3,641)	(3,499)	(3,447)
Provision for income taxes	(1)	(32)	(48)	(92)
Loss from continuing operations	(1,978)	(3,673)	(3,547)	(3,539)
Loss from discontinued operations, net of income taxes	(26)	(102)	(151)	(119)
Gain on sale of discontinued operations, net of income taxes	496	1,530	509	1,553
Net loss	$ (1,508)	$ (2,245)	$ (3,189)	$ (2,105)
Loss per share from continuing operations:				
Basic and diluted	$ (0.13)	$ (0.23)	$ (0.22)	$ (0.23)
Gain per share from discontinued operations:				
Basic and diluted	$ 0.03	$ 0.09	$ 0.02	$ 0.09
Net loss per share:				
Basic and diluted	$ (0.10)	$ (0.14)	$ (0.20)	$ (0.14)
Shares used to compute basic and diluted income (loss) per share	15,744	15,730	15,742	15,715
Comprehensive loss:				

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

See notes to condensed consolidated financial statements.

Table of Contents

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

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

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

See notes to condensed consolidated financial statements.

Table of Contents

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

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

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

See notes to condensed consolidated financial statements.

Table of Contents

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

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of our financial position, results of operations and cash flows have been included. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008 or any future period. For further information, refer to the financial statements and notes thereto included in SCM Microsystems, Inc. s (SCM or the Company) Annual Report on Form 10-K for the year ended December 31, 2007. The preparation of our unaudited condensed consolidated financial statements necessarily requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented.

Discontinued Operations

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its Digital Television solutions (DTV solutions) business to Kudelski S.A. (Kudelski) for a total consideration of $10.6 million in cash, of which $9.0 million was paid at the time of sale and $1.6 million was paid in May 2007.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and six months ended June 30, 2008 and 2007, this business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation. See Note 3 for further discussion of this transaction.

Recent Accounting Pronouncements and Accounting Changes

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

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

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

6

Table of Contents

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

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

Level 1 Quoted prices for identical instruments in active markets;

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

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

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

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

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

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

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

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

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

2. Stock Based Compensation

The Company has a stock-based compensation program that provides its Board of Directors discretion in creating employee equity incentives. This program includes incentive and non-statutory stock options under various plans, the majority of which are stockholder approved. Stock options are generally time-based and expire seven to ten years from the date of grant. Vesting varies, with some options vesting 25% each year over four years; some vesting 1/12th per month over one year; some vesting 100% after one year; and some vesting 1/12th per month, commencing four years from the date of grant.

The Company previously had an Employee Stock Purchase Plan (ESPP) that allowed employees to purchase shares of common stock at 85% of the fair market value at the lower of either the date of enrollment or the date of purchase. Shares issued as a result of stock option exercises and purchases under the Company s ESPP were newly issued shares. The Company s ESPP, Director Option Plan and 1997 Stock Option Plan all expired in March 2007. In November 2007, stockholders approved the 2007 Stock Option Plan, which authorizes the issuance of up to 1.5 million shares of the Company s common stock pursuant to stock option grants.

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

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

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

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

Stock Option Plans

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

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

Table of Contents

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

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

The weighted-average grant date fair value per option for options granted during the three and six months ended June 30, 2008 was $1.38 and $1.39, respectively. The weighted-average grant date fair value per option for options granted during the three and six months ended June 30, 2007 was $1.02 and $1.91, respectively. The total intrinsic value of options exercised during the three and six months ended June 30, 2008 was $0 and $1,500, respectively. The total intrinsic value of options exercised during the three and six months ended June 30, 2007 was $7,578 and $8,331, respectively. Cash proceeds from the exercise of stock options were $0 and $18,000 for the three and six months ended June 30, 2008, respectively. Cash proceeds from the exercise of stock options were $30,149 and $33,135 for the three and six months ended June 30, 2007, respectively. An income tax benefit of less than $1,000 was realized from stock option exercises during both the three and six months ended June 30, 2008. No income tax benefit was realized from stock option exercises during both the three and six months ended June 30, 2007. At June 30, 2008, there was $1.0 million of unrecognized stock-based compensation expense, net of estimated forfeitures related to non-vested options, that is expected to be recognized over a weighted-average period of 3.0 years.

The fair value of option grants was estimated by using the Black-Scholes-Merton model with the following weighted-average assumptions for the three and six months ended June 30, 2008 and 2007, respectively:

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

Expected term (in years)	4.00	4.00	4.00	4.00

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

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

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

Expected Term: The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined for both the three and six months ended June 30, 2008 based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior.

Forfeitures Rate: Compensation expense recognized in the consolidated statement of operations for both the three and six months ended June 30, 2008 and 2007 is based on awards ultimately expected to vest and it reflects estimated forfeitures. FASB SFAS No. 123 revised 2004 (SFAS 123(R)) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to adoption of SFAS 123(R), the Company accounted for forfeitures as they occurred.

1997 Employee Stock Purchase Plan

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

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

3. Discontinued Operations

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its DTV solutions business to Kudelski for a total consideration of $10.6 million in cash, of which $9.0 million was paid at the time of sale and $1.6 million, which was paid in May 2007.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for both the three and six months ended June 30, 2008, the DTV solutions business has been presented as discontinued operations in the unaudited consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

Based on the carrying value of the assets and the liabilities attributed to the DTV solutions business on May 22, 2006, and the estimated costs and expenses incurred in connection with the sale, the Company recorded a net pretax gain of approximately $5.5 million. An additional $1.5 million gain on sale of discontinued operations was realized in May 2007 primarily resulting from the final payment by Kudelski as described above.

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

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net revenue	$	$	$	$496
Operating loss	$(2)	$(46)	$	