PRECISION OPTICS CORPORATION INC
Form S-1/A
April 06, 2009

Table of Contents

As filed with the Securities and Exchange Commission on April 6, 2009

Registration Statement No. 333-156258

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM S-1/A

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

PRECISION OPTICS CORPORATION, INC.

(Exact name of registrant as specified in its charter)

Massachusetts	**3845**	**04-2795294**
(State or other jurisdiction of incorporation or organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification Number)

Precision Optics Corporation, Inc.
22 East Broadway
Gardner, Massachusetts 01440
(978) 630-1800
(Address, including zip code, and telephone number,
including area code, of registrant s principal executive

Richard Forkey
Precision Optics Corporation, Inc.
22 East Broadway
Gardner, Massachusetts 01440
(978) 630-1800
(Name, address, including zip code, and telephone number,
including area code, of agent for service)

offices)

Copies of communications to:
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Approximate date of proposed sale to the public: From time to time after this registration statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box: x

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Table of Contents

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is declared effective. This prospectus is not an offer to sell these securities, and we are not soliciting offers to buy these securities, in any state where the offer or sale is not permitted.

PROSPECTUS

PRECISION OPTICS CORPORATION, INC.

OFFERING UP TO 960,439 COMMON SHARES

This prospectus relates to the sale or other disposition of up to 960,439 shares of our common stock by selling stockholders. We are not selling any securities in this offering and therefore will not receive any proceeds from this offering. We may receive proceeds from the possible future exercise of warrants. All costs associated with this registration will be borne by us. Our common stock is traded on the Over-The-Counter Bulletin Board under the trading symbol PEYE.OB. On March 30, 2009, the last reported sale price of our common stock on the Over-The-Counter Bulletin Board was $0.25 per share.

THIS INVESTMENT INVOLVES A HIGH DEGREE OF RISK. YOU SHOULD PURCHASE

SECURITIES ONLY IF YOU CAN AFFORD A COMPLETE LOSS.

SEE RISK FACTORS BEGINNING ON PAGE 2.

You should rely only on the information provided in this prospectus or any supplement to this prospectus and information incorporated by reference. We have not authorized anyone else to provide you with different information. Neither the delivery of this prospectus nor any distribution of the shares of common stock pursuant to this prospectus shall, under any circumstances, create any implication that there has been no change in our affairs since the date of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Subject to completion, the date of this prospectus is April 6, 2009.

Table of Contents

TABLE OF CONTENTS

		Page
Prospectus Summary		1
Risk Factors		2
Use of Proceeds		7
Selling Security Holders		7
Plan of Distribution		13
Description of Securities Being Registered		14
Interests of Named Experts and Counsel		14
Information About the Company		15
	Description of Business	15
	Descriptions of Property	18
	Legal Proceedings	19
	Market Price of and Dividends on Common Equity and Related Stockholder Matters	19
	Financial Statements	21
	Management s Discussion and Analysis of Financial Conditions and Results of Operations	46
	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	53
	Directors, Executive Officers, Promoters and Control Persons	53
	Executive Compensation	54
	Security Ownership of Certain Beneficial Owners and Management	56
	Transactions with Related Persons, Promoters and Certain Control Persons, Director Independence	58
Disclosure of Commission Position on Indemnification for Securities Act Liabilities		59

Table of Contents

PRECISION OPTICS CORPORATION, INC.

PROSPECTUS SUMMARY

The following information is a summary of the prospectus and it does not contain all of the information you should consider before making an investment decision. You should read the entire prospectus carefully, including the financial statements and the notes relating to the financial statements.

ABOUT US

We incorporated in Massachusetts in December 1982 and have been publicly-owned since November 1990. References to our Company contained in this prospectus include our two wholly-owned subsidiaries, Precise Medical, Inc. and Wood s Precision Optics Corporation, Limited, except where the context otherwise requires. Our fiscal year end is June 30. Our principal executive offices are located at 22 East Broadway, Gardner, Massachusetts 01440-3338. Our telephone number is (978) 630-1800. Our website is www.poci.com. Information contained on our website does not constitute part of this prospectus.

We have been a developer and manufacturer of advanced optical instruments since 1982. We design and produce high-quality medical instruments, optical thin film coatings, micro-optics with characteristic dimensions less than 1 millimeter, or mm, and other advanced optical systems. Our medical instrumentation line includes laparoscopes, arthroscopes and endocouplers and a line of world-class 3-D endoscopes for use in minimally invasive surgical procedures. We are registered to the ISO 9001:2000, ISO 13485:2003, and Canadian Medical Devices Conformity Assessment System, or CMDCAS, Quality Standards, and comply with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE marking of our medical products.

THE OFFERING

Common stock outstanding as of April 3, 2009	1,018,411 shares
Common stock to be registered	960,439 shares includes 480,000 shares underlying senior secured convertible notes and 480,439 shares underlying warrants.
Use of proceeds	We will not receive any proceeds from the sale or other disposition of common stock by the selling stockholders. We may receive proceeds from the exercise of warrants. We intend to use the proceeds from the exercise of warrants, if any, for working capital purposes.
Stock symbol	PEYE.OB

THE TRANSACTION

On June 25, 2008, we entered into a Purchase Agreement with institutional and other accredited investors pursuant to which we sold a total of $600,000 of 10% Senior Secured Convertible Notes, referred to as the Notes, that are convertible into a total of 480,000 shares of our common stock at a conversion rate of $1.25. We also issued warrants to purchase a total of 316,800 shares of our common stock at an exercise price of $1.75 per share, referred to as the Warrants. Interest accrues on the Notes at a rate of 10% per year and is payable in cash upon the earlier of conversion or maturity of the Notes. The Notes mature on June 25, 2010 and the Warrants expire on June 25, 2015, subject to extension.

Pursuant to the Purchase Agreement, the Notes and Warrants were not convertible or exercisable until we implemented a 1 for 6 reverse stock split, which required the approval of our stockholders. On November 25, 2008, we entered into a Side Letter Agreement in which the investors agreed to change the ratio of the reverse split from 1 for 6 to 1 for 25. On December 11, 2008, we effected a 1 for 25 reverse split of our common stock.

Pursuant to a Registration Rights Agreement entered into with the investors on June 25, 2008, we agreed to file a registration statement with the Securities and Exchange Commission by the earlier of (i) two days following the effectiveness of the amendment to implement a reverse stock split and (ii) December 15, 2008, to register the resale of the common stock issuable upon the conversion of the Notes and the exercise of the Warrants. We agreed to keep the registration statement effective until the earlier of (i) the date on which all the securities covered by the registration statement, as amended from time to time, have been sold and (ii) the date on which all the securities covered by such registration statement may be sold without restriction pursuant to Rule 144 of the Securities Act of 1933.

On February 1, 2007, we entered into a Purchase Agreement with institutional and other accredited investors pursuant to which we sold a total of 400,000 shares of our common stock. We also issued warrants to purchase a total of 400,000 shares of our common stock at an exercise price of $8.00 per share. The warrants expire on February 1, 2012. The selling stockholders that participated in this offering as follows:

Selling stockholder	**Common shares purchased in February 1, 2007 offering**	**Warrants purchased in February 1, 2007 offering**		**Amount paid for common stock and warrants**
Special Situations Fund III QP, L.P.	160,000	160,000	$	1,000,000
Special Situations Private Equity Fund, L.P.	160,000	160,000	$	1,000,000
Arnold Schumsky	24,000	24,000	$	150,000
Joel Pitlor	40,000	40,000	$	250,000
LaPlace Group LLC	16,000	16,000	$	100,000
TOTAL	**400,000**	**400,000**	**$**	**2,500,000**

As part of the February 2007 private placement, we entered into a Registration Rights Agreement pursuant to which we agreed to file a registration statement with the SEC within forty-five days after the closing date to register the resale of the shares of common stock and the shares of common stock issuable upon exercise of the warrants. We also agreed to keep the registration statement effective until the earlier of (i) such time as all of the shares covered by the Registration Statement have been sold or (ii) the date on which the shares may be sold pursuant to Rule 144 of the Securities Act of 1933. The SEC declared the registration statement registering these shares effective on March 23, 2007. In the event additional shares become issuable upon the exercise of the warrants, we agreed to register such additional shares to the extent that such shares are not covered by an effective registration statement.

As a result of the June 25, 2008 transaction described above, certain anti-dilution provisions were triggered and we were obligated to issue 181,821 additional shares upon the exercise of the warrants issued February 1, 2007. Additionally, the exercise price of the warrants was reduced from $8.00 to $5.50. Pursuant to the February 1, 2007 Registration Rights Agreement, we are registering certain of these additional shares in this Registration Statement to which this prospectus forms a part. Mr. Pitlor, our Director, has agreed to waive his registration rights as they pertain to this Registration Statement.

USE OF PROCEEDS

We will not receive any proceeds from the sale or other disposition of our common stock by selling stockholders. We may receive proceeds from the exercise of warrants. We intend to use the proceeds from the exercise of warrants, if any, for working capital.

MARKET FOR THE SECURITIES

Our common stock is traded on the Over-The-Counter Bulletin Board, or OTCBB, under the symbol PEYE.OB.

RISK FACTORS

Risks Related to Our Business

An investment in our common stock involves a high degree of risk. You should carefully consider the following risk factors and other information included in this prospectus. If any of the following risks actually occur, our business, financial condition or results of operations could be materially and adversely affected and you may lose some or all of your investment.

Our independent auditors have issued a going concern opinion and, if we do not generate enough cash from operations to sustain our business, we may have to liquidate assets or curtail our operations.

The accompanying financial statements have been prepared assuming we will continue as a going concern. During the years ended June 30, 2008 and 2007, we incurred net losses of $1,623,354 and $2,889,829, respectively. Our auditors have issued a going concern

Table of Contents

qualification in their opinion related to our financial statements for the period ended June 30, 2008. This opinion is based on our history of operating losses, negative cash flows from operations, and our cash position as of June 30, 2008.

Conditions exist which raise substantial doubt about our ability to continue as a going concern. Our ability to continue as a going concern depends on our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitable operations. However, we may not be able to obtain additional financing or achieve profitable operations or sufficient cash flows in the future.

The current worldwide economic downturn could have a negative impact on our business, operating results and financial condition.

If the economic downturn continues, our customers may delay, reduce or cancel their purchases of our products, particularly if they or their customers have difficulty obtaining credit, which could reduce our revenues. The economic downturn could increase competition which could have the effect of reducing our prices. We could incur losses if a customer s business fails and is unable to pay us, or pay us on a timely basis. Likewise, if our suppliers have difficulty in obtaining credit or in operating their businesses, they may not be able to provide us with the materials we use to manufacture our products. These actions could result in reduced revenues and higher operating costs, and have an adverse effect on our results of operations and financial condition.

Our existing and future debt obligations could impair our liquidity and financial condition.

Effective June 25, 2008, we completed a financing in which we issued 10% Senior Secured Convertible Notes and Warrants. As of December 31, 2008, we had outstanding notes payable of $600,000 and we may incur additional debt in the future to fund all or part of our capital requirements. Our outstanding debt and future debt obligations could impair our liquidity and could:

- make it more difficult for us to satisfy our other obligations;

- require us to dedicate a substantial portion of any cash flow we may generate to payments on our debt obligations, which would reduce the availability of our cash flow to fund working capital, capital expenditures and other corporate requirements;

- impede us from obtaining additional financing in the future for working capital, capital expenditures, acquisitions and general corporate purposes; and

- make us more vulnerable in the event of a downturn in our business prospects and limit our flexibility to plan for, or react to, changes in our industry.

If we were to fail in the future to make any required payment under agreements governing indebtedness, or equity issues, or fail to comply with the financial and operating covenants contained in those agreements, we would be in default in regards to that financing transaction. A debt default could significantly diminish the market value and marketability of our common stock. Our lenders would have the ability to require that we immediately pay all outstanding indebtedness, and we might not have sufficient assets to satisfy their demands. In this event, we may be forced to seek protection under bankruptcy laws, which could harm our future operations and overall financial condition.

We rely on a small number of customers who may not consistently purchase our products in the future and if we lose any one of these customers, our revenues may decline.

In the fiscal year ended June 30, 2008, our three largest customers represented approximately 25%, 20% and 11%, respectively, of our total revenues. In the fiscal year ended June 30, 2007, our three largest customers represented approximately 27%, 22% and 10%, respectively, of our total revenues. No other customer accounted for more than 10% of our revenues during those periods. At June 30, 2008, receivables from our three largest customers were 27%, 25% and 17%, respectively, of the total accounts receivable.

In the future, a small number of customers may continue to represent a significant portion of our total revenues in any given period. These customers may not consistently purchase our products at a particular rate over any subsequent period. A loss of any of these customers could adversely affect our revenues.

We rely heavily upon the talents of our Chief Executive Officer and Chief Scientific Officer, the loss of whom could severely damage our business.

Our performance depends to a large extent on a small number of key scientific, technical, managerial and marketing personnel. In particular, we believe our success is highly dependent upon the services and reputation of our Chief Executive Officer, Mr. Richard E. Forkey. Loss of Mr. Forkey s services could severely damage our business.

Additionally, Dr. Joseph N. Forkey, our Executive Vice President and Chief Scientific Officer, provides highly valuable contributions to our capabilities in optical instrument development, in management of new technology and in potentially significant longer-term initiatives in biophysics and biomedical instrumentation. The loss of Dr. Forkey s management and scientific contributions could severely damage our business.

We must continue to be able to attract employees with the scientific and technical skills that our business requires and if we are unable to attract and retain such individuals, our business could be severely damaged.

Our ability to attract employees with a high degree of scientific and technical talent is crucial to the success of our business. There is intense competition for the services of such persons, and we cannot guarantee that we will be able to attract and retain individuals possessing the necessary qualifications. If we cannot attract such individuals, we may not be able to produce our products and our business could be damaged.

We are subject to a high degree of regulatory oversight and, if we do not continue to receive the necessary regulatory approvals, our revenues may decline.

The FDA has allowed us to market the medical products we currently sell in the United States. However, prior FDA approval may be required before we can market additional medical products that we may develop in the future. We may also seek to sell current or future medical products in a manner that requires us to obtain FDA permission to market such products. We may also require the regulatory approval or license of other federal, state or local agencies or comparable agencies in other countries.

We may not continue to receive the FDA s permission to market our current products or may not obtain the necessary regulatory permission, approvals or licenses for the marketing of any of our future products. Also, we cannot predict the impact on our business of FDA regulations or determinations arising from future legislation or administrative action. If we lose the FDA s permission to market our current products or we do not obtain regulatory permission to market our future products, our revenues may decline and our business may be harmed.

We face risks inherent in product development and production under fixed price purchase orders and these purchase orders may not be profitable over time.

A portion of our business has been devoted to research, development and production under fixed price purchase orders. For our purposes, a fixed price purchase order is any purchase order under which we will provide products or services for a fixed price over an extended period of time, usually six months or longer. Fixed price purchase orders represented approximately 25% to 50% of our total revenues during the last several years. We expect that revenues from fixed price purchase orders will continue to represent a significant portion of our total revenues in future fiscal years.

Because they involve performance over time, we cannot predict with certainty the expenses involved in meeting our obligations under fixed price purchase orders. Therefore, we can never be sure at the time we enter into any single fixed price purchase order that such purchase order will be profitable for us.

Third parties may infringe on our patents and as a result, we could incur significant expense in protecting our patents or not have sufficient resources to protect them.

We hold a number of patents that are important to our business. Although we are not currently aware of any past or present infringements of our patents, we plan to protect these patents from infringement and obtain additional patents whenever feasible. To this end, we have obtained confidentiality agreements from our employees and consultants and others who have access to the design of our products and other proprietary information. Protecting and obtaining patents, however, is both time consuming and expensive. We therefore may not have the resources necessary to assert all potential patent infringement claims or pursue all patents that might be available to us. If our competitors or other third parties infringe on our patents, our business may be harmed.

Third parties may claim that we have infringed on their patents and as a result, we could be prohibited from using all or part of any technology used in our products.

Should third parties claim a proprietary right to all or part of any technology that we use in our products, such a claim, regardless of its merit, could involve us in costly litigation. If successful, such a claim could also result in us being unable to freely use the technology that was the subject of the claim, or sell products embodying such technology. If we engage in litigation, our expenses may increase and our business may be harmed. If we are prohibited from using a particular technology in our products, our revenues may decline and our business may be harmed.

Table of Contents

We depend on the availability of certain key supplies and services that are available from only a few sources and if we experience difficulty with a supplier, we may have difficulty finding alternative sources of supply.

We require certain key supplies for our products, particularly precision grade optical glass, that are available from only a few sources, each of which is located outside the United States. Also, outside vendors grind and polish certain of our lenses and other optical components, such as prisms and windows. Based upon our ordering experience to date, we believe the materials and services required for the production of our products are currently available in sufficient quantities. Our requirements are small relative to the total supply, and we are not currently encountering problems with availability. However, this does not mean that we will continue to have timely access to adequate supplies of essential materials and services in the future or that supplies of these materials and services will be available on satisfactory terms when the need arises. Our business could be severely damaged if we become unable to procure essential materials and services in adequate quantities and at acceptable prices.

From time to time, subcontractors may produce certain of our products for us, and our business is subject to the risk that these subcontractors fail to make timely delivery. Our products and services are also from time to time used as components of the products and services of other manufacturers. We are therefore subject to the risk that manufacturers that integrate our products or services into their own products or services are unable to acquire essential supplies and services from third parties in a timely fashion. If this occurs, we may not be able to deliver our products on a timely basis and our revenues may decline.

Our customers may claim that the products we sold them were defective and if our insurance is not sufficient to cover a claim, we would be liable for the excess.

Like any manufacturer, we are and always have been exposed to liability claims resulting from the use of our products. We maintain product liability insurance to cover us in the event of liability claims, and as of December 15, 2008, no such claims have been asserted or threatened against us. However, our insurance may not be sufficient to cover all possible future product liabilities.

We would be liable if our business operations harmed the environment and a failure to maintain compliance with environmental laws could severely damage our business.

Our operations are subject to a variety of federal, state and local laws and regulations relating to the protection of the environment. From time to time, we use hazardous materials in our operations. Although we believe that we are in compliance with all applicable environmental laws and regulations, our business could be severely damaged by any failure to maintain such compliance.

Our quarterly financial results vary quarter to quarter which may adversely affect our stock price. As a result, we cannot predict with a high degree of certainty our operating results in any particular fiscal quarter.

Our quarterly operating results may vary significantly depending upon factors such as:

- the timing of completion of significant orders;
- the timing and amount of our research and development expenditures;
- the costs of initial product production in connection with new products;
- the timing of new product introductions both by us and by our competitors;
- the timing and level of market acceptance of new products or enhanced versions of our existing products;
- our ability to retain existing customers and customers continued demand for our products and services;
- our customers inventory levels, and levels of demand for our customers products and services; and
- competitive pricing pressures.

We may not be able to grow or sustain revenues or achieve or maintain profitability on a quarterly or annual basis and levels of revenue and/or profitability may vary from one such period to another.

We have a number of large, well-financed competitors who have research and marketing capabilities that are superior to ours.

The industries in which we compete are highly competitive. Many of our existing and potential competitors have greater financial resources and manufacturing capabilities, more established and larger marketing and sales organizations and larger technical staffs than we have. Other companies, some with greater experience in the telecommunications, optics, semiconductor or medical products industries, are seeking to produce products and services that compete with our products and services.

Table of Contents

Risks Related to Our Stock

Trading in our common stock is limited and the price of our common stock may be subject to substantial volatility.

Our common stock was delisted from the NASDAQ Capital Market at the opening of business on December 27, 2005, and is now traded on the Over-The-Counter Bulletin Board, or OTCBB, under the ticker symbol PEYE.OB, where we expect our common stock to remain for the near future. Broker-dealers often decline to trade in OTCBB stocks given the market for such securities is often limited, the stocks are more volatile and the risk to investors is greater. These factors may reduce the potential market for our common stock by reducing the number of potential investors. This may make it more difficult for investors in our common stock to sell shares to third parties or to otherwise dispose of their shares. This could cause our stock price to decline.

Additionally, the price of our common stock may be volatile as a result of a number of factors, including, but not limited to, the following:

- our ability to successfully conceive and to develop new products and services to enhance the performance characteristics and methods of manufacture of existing products;
- our ability to retain existing customers and customers continued demand for our products and services;
- the timing of our research and development expenditures and of new product introductions;
- the timing and level of acceptance of new products or enhanced versions of our existing products; and
- price and volume fluctuations in the stock market at large which do not relate to our operating performance.

Penny stock rules may make buying or selling our securities difficult which may make our stock less liquid and make it harder for investors to buy and sell our securities.

Trading in our securities is subject to the SEC s penny stock rules and it is anticipated that trading in our securities will continue to be subject to the penny stock rules for the foreseeable future. The SEC has adopted regulations that generally define a penny stock to be any equity security that has a market price of less than $5.00 per share, subject to certain exceptions. These rules require that any broker-dealer who recommends our securities to persons other than prior customers and accredited investors must, prior to the sale, make a special written suitability determination for the purchaser and receive the purchaser s written agreement to execute the transaction. Unless an exception is available, the regulations require the delivery, prior to any transaction involving a penny stock, of a disclosure schedule explaining the penny stock market and the risks associated with trading in the penny stock market. In addition, broker-dealers must disclose commissions payable to both the broker-dealer and the registered representative and current quotations for the securities they offer. The additional burdens imposed upon broker-dealers by these requirements may discourage broker-dealers from recommending transactions in our securities, which could severely limit the liquidity of our securities and consequently adversely affect the market price for our securities.

We are contractually obligated to issue shares in the future, diluting your interest in us.

As of December 15, 2008, there were approximately 93,178 shares of our common stock issuable upon exercise of stock options outstanding, at a weighted average exercise price of $16.17 per share. An additional 135,898 shares of our common stock are reserved for issuance under our 2006 Equity Incentive Plan as of December 15, 2008. Also outstanding as of December 15, 2008 are warrants for the issuance of an additional 898,621 shares of our common stock, at a weighted average exercise price of $4.18 per share. The foregoing information gives effect to a 1 for 25 reverse stock split effective December 11, 2008. Moreover, we expect to issue additional shares and options to purchase shares of our common stock to compensate employees, consultants and directors, and we may issue additional shares to raise capital. Any such issuances will have the effect of further diluting the interest of the holders of our securities.

CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements that involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including the reasons described in our Risk Factor section. Although we believe the expectations reflected in the forward-looking statements are reasonable, they relate only to events as of the date on which the statements are made. We do not intend to update any of the forward-looking statements after the date of this prospectus to conform these statements to actual results or to changes in our expectations, except as required by law.

USE OF PROCEEDS

This prospectus relates to shares of our common stock that may be offered and sold from time to time by certain selling stockholders. We will not receive proceeds from the sale or other disposition of shares of common stock being sold by our selling stockholders. However, we may receive proceeds from the exercise of warrants. We cannot predict when or if the warrants will be exercised. It is possible that the warrants may expire and may never be exercised. If we receive proceeds from the exercise of warrants, we intend to use the proceeds for working capital.

SELLING SECURITY HOLDERS

Based upon information available to us as of April 3, 2009, the following table sets forth the names of the selling stockholders, the number of shares owned, the number of shares registered by this Registration Statement and the number and percent of outstanding shares that the selling stockholders will own, assuming all of the shares are sold. The information provided in the table and discussions below has been obtained from the selling stockholders. The selling stockholders may have sold, transferred or otherwise disposed of, or may sell, transfer or otherwise dispose of, at any time or from time to time since the date on which it provided the information regarding the shares beneficially owned, all or a portion of the shares of common stock beneficially owned in transactions exempt from the registration requirements of the Securities Act of 1933. As used in this prospectus,   selling stockholder   includes donees, pledgees, transferees or other successors-in-interest selling shares received from the named selling stockholder as a gift, pledge, distribution or other transfer.

Beneficial ownership is determined in accordance with Rule 13d-3(d) promulgated by the Commission under the Securities Exchange Act of 1934. Unless otherwise noted, each person or group identified possesses sole voting and investment power with respect to the shares, subject to community property laws where applicable.

Name of Selling Security Holder	**Ownership Before Offering (1)**	**Percentage of Outstanding Shares Owned Prior to Offering (2)**	**Number of Shares Offered**	**Number of Shares Owned After Offering (3)**	**Percentage of Outstanding Shares Owned After Offering (3)**
Special Situations Fund III QP, L.P. (4)(5)	1,591,133	71.9%	437,928	715,277	53.4%
Special Situations Private Equity Fund, L.P. (4)(6)	1,591,133	71.9%	437,928	715,277	53.4%
Arnold Schumsky (7)	140,339	13.8%	77,310	63,029	5.3%
LaPlace Group LLC (8)	39,273	13.%	7,273	32,000	3.1%

* All information set forth herein gives effect to a 1 for 25 reverse stock split on December 11, 2008.

(1) Includes common stock beneficially owned, including shares being registered by this prospectus.

(2) Based on 1,018,411 shares outstanding as of April 3, 2009.

(3) These numbers assume the selling stockholders sell all of their shares being registered in this Registration Statement subsequent to the completion of the offering.

(4) MGP Advisors Limited, or MGP, is the general partner of the Special Situations Fund III, QP, L.P. AWM Investment Company, Inc., or AWM, is the general partner of MGP, the general partner of and investment adviser to the Special Situations Private Equity Fund, L.P. Austin W. Marxe and David M. Greenhouse are the principal owners of MGP and AWM. Through their control of MGP and AWM, Messrs. Marxe and Greenhouse share voting and dispositive control over the portfolio securities of each of the funds listed above.

Table of Contents

(5) The shares being registered for Special Situations Fund III QP, L.P. are issuable upon exercise of Warrants and conversion of a 10% Senior Secured Convertible Note with a face value of $275,000 issued in exchange for $275,000, as part of a private placement that closed June 25, 2008. The Warrants are exercisable at $1.75 per share to purchase 145,200 shares of our common stock and expire on June 25, 2015, subject to extension. The Note is convertible at a rate of $1.25 into 220,000 shares of our common stock and matures on June 25, 2010. Additionally, we are registering 72,728 of the 232,728 shares issuable upon conversion of a warrant with an exercise price of $5.50 per share and expiration date of February 1, 2012. The number of shares issuable under the warrant increased as a result of anti-dilution provisions in the warrant being triggered on June 25, 2008.

(6) The shares being registered for Special Situations Private Equity Fund, L.P. are issuable upon exercise of Warrants and conversion of a 10% Senior Secured Convertible Note with a face value of $275,000 issued in exchange for $275,000, as part of a private placement that closed June 25, 2008. The Warrants are exercisable at $1.75 per share to purchase 145,200 shares of our common stock and expire on June 25, 2015, subject to extension. The Note is convertible at a rate of $1.25 into 220,000 shares of our common stock and matures on June 25, 2010. Additionally, we are registering 72,728 of the 232,728 shares issuable upon conversion of a warrant with an exercise price of $5.50 per share and expiration date of February 1, 2012. The number of shares issuable under the warrant increased as a result of anti-dilution provisions in the warrant being triggered on June 25, 2008.

(7) The shares being registered for Arnold Schumsky are issuable upon exercise of Warrants and conversion of a 10% Senior Secured Convertible Note with a face value of $50,000, as part of a private placement that closed June 25, 2008. The Warrants are exercisable at $1.75 per share to purchase 26,400 shares of our common stock and expire on June 25, 2015, subject to extension. The Note is convertible at a rate of $1.25 into 40,000 shares of our common and matures on June 25, 2010. Additionally, we are registering 10,910 of the 34,910 shares issuable upon conversion of a warrant with an exercise price of $5.50 per share and expiration date of February 1, 2012. The number of shares issuable under the warrant increased as a result of anti-dilution provisions in the warrant being triggered on June 25, 2008.

(8) Reuven Dessler, as managing member for LaPlace Group LLC, has voting and dispositive control over the shares. We are registering 7,273 of the 23,273 shares issuable upon conversion of a warrant with an exercise price of $5.50 per share and expiration date of February 1, 2012. The number of shares issuable under the warrant increased as a result of anti-dilution provisions in the warrant being triggered on June 25, 2008.

Net Proceeds from the Sale of the Notes

The net proceeds to our Company from the sale of the Notes in the June 25, 2008 transaction were $600,000.

Total Possible Payments to all Selling Stockholders and their Affiliates in the First Year Following the Sale of the Notes

During the first year following the sale of the Notes, there are no payments due to the selling stockholders and their affiliates. The Notes are not due until the maturity date of June 25, 2010 and they are not prepayable or redeemable prior to that date. A holder may elect to convert some or the entire Note and accrued but unpaid interest with respect to such portion to be converted into shares of our common stock prior to the maturity date. Notwithstanding the foregoing, upon the occurrence of an event of default, all unpaid principal and accrued interest under the Note may become immediately due and payable.

Table of Contents

Payments Made or to be Made in Connection with the June 25, 2008 Financing to Participating Selling Stockholders and their Affiliates (1)

The following table discloses the dollar amount of each payment (including the value of any payments to be made in common stock) in connection with the June 25, 2008 transaction that we have made or may be required to make to any selling stockholder, any affiliate of a selling stockholder, or any person with whom any selling stockholder has a contractual relationship regarding the transaction (including any interest payments, liquidated damages, payments made to finders or placement agents, and any other payments or potential payments).

Payments Under Purchase Agreement		
Expenses paid to investors counsel for legal fees and expenses (2)	$	33,048
Payments Under 10% Senior Secured Convertible Note		
Interest assuming Notes are held in full until maturity on June 25, 2010 (3)	$	120,000
Liquidated damages for failure to pay outstanding amounts when due (4)(5)		*
Expenses in the event of default (4)(6)		*
Payments Under Warrants		
Buy-in payment (4)(7)		*
Payments Under Registration Rights Agreement		
Liquidated damages for failure to have Registration Statement filed by December 15, 2008 (8)		0
Liquidated damages for failure to file or amend a registration statement to include anti-dilution shares that may become due to holders under the Note or Warrant (4)(9)		*
Liquidated damages for failure to file a shelf registration statement to include registrable securities and anti-dilution shares, if any (4)(10)		*
Liquidated damages for failure to have Registration Statement effective by the required deadline (4)(11)	$	3,600
Indemnification of investors (4)(12)		*

(1) All payments due to Special Situations Fund III QP, L.P. and Special Situations Private Equity Fund, L.P. will be made to the funds themselves. MGP Advisors Limited, or MGP, is the general partner of the Special Situations Fund III, QP, L.P. AWM Investment Company, Inc., or AWM, is the general partner of MGP, the general partner of and investment adviser to the Special Situations Private Equity Fund, L.P. Austin W. Marxe and David M. Greenhouse are the principal owners of MGP and AWM. Through their control of MGP and AWM, Messrs. Marxe and Greenhouse share voting and dispositive control over the portfolio securities of each of the funds.

(2) We agreed to pay the reasonable fees and expenses, not to exceed $35,000, of counsel to Special Situations Fund III QP, L.P. and Special Situations Private Equity Fund, L.P. Such expenses were to be paid on demand. In addition, we agreed to reimburse the investors upon demand for all reasonable out-of-pocket expenses incurred by the investors, including without limitations, reimbursement of attorneys fees and disbursements, in connection with any amendment, modification or waiver of the Purchase Agreement or any other agreement entered into in connection with this financing transaction.

(3) Interest accrues on the Notes at a rate of 10% per year and will accrue on the unpaid principal balance of the Notes outstanding until the Notes are converted into shares of our common stock or paid in full. The interest is payable upon the earlier of conversion or maturity of the Notes. The Notes are due June 25, 2010.

(4) We are unable to estimate at this time if any such payments will be payable, or, if payable, what such amount would be. This is a potential payment that we may or may not incur.

(5) In the event that any amount due under the Notes is not paid when due, such overdue amount shall bear interest at an annual rate of 15% until paid in full. In no event may any interest charged, collected or reserved under the Notes exceed the maximum rate permitted by law.

(6) If an event of default occurs, we agreed to pay to the holder the reasonable attorneys fees and disbursements and all other reasonable out-of-pocket costs incurred by the holder in order to collect amounts due and under the Notes or otherwise to enforce the holders rights and remedies to which they are entitled.

(7) If we do not deliver a certificate representing the shares issuable upon the due exercise of the Warrant by the holder within three business days and prior to the time such certificate is received by the holder, the holder, or any third party on behalf of the holder or for the holder s account, purchases (in an open market transaction or otherwise) shares of our common stock to deliver in satisfaction of a sale by the holder of shares represented by such certificate, referred to as a Buy-In, then we must pay in cash to the holder (for costs incurred either directly by such holder or on behalf of a third party) the amount by which the total purchase price paid for the common stock as a result of the Buy-In (including brokerage commissions, if any) exceeds the proceeds received by such holder as a result of the sale to which such Buy-In relates.

(8) Investors are entitled to pro rata payments in cash, in an amount equal to 1% of the aggregate amount invested by each investor for each 30-day period or pro rata for any portion thereof following December 15, 2008 for which we did not have this Registration Statement filed with the SEC. We filed the Registration Statement two days late, however the Note holders agreed to waive the liquidated damages.

(9) Investors are entitled to pro rata payments in cash, in an amount equal to 1% of the aggregate amount invested by each investor for each 30-day period or pro rata for any portion thereof following the 30th day after the obligation arises.

(10) Investors will be entitled to pro rata payments in an amount equal to 1% of the aggregate amount invested by each investor attributable to those registrable securities that remain unsold at that time for each 30-day period or pro rata portion thereof following the day the obligation to file a shelf registration statement arises.

(11) Investors will be entitled to pro rata payments in cash, in an amount equal to 1% of the aggregate amount invested by each investor for each 30-day period or pro rata for any portion thereof following the date the Registration Statement should have been effective. As of April 3, 2009, we would be required to pay approximately $3,600.

(12) We have agreed to indemnify the investors for any losses, claims, damages or liabilities they may incur as a result of any untrue statement of material fact in any registration statement; any blue sky application or document filed in any state; an omission to state a material fact in a blue sky application or other document necessary to make the statements therein not misleading; any violation by our Company or our agents of any rule or regulation promulgated under the Securities Act of 1933 relating to action or inaction required of our Company in connection with such registration other than any violation resulting from our compliance with our obligations related to Rule 415 as set forth in the Registration Rights

Agreement; or any failure to register or qualify the securities included in the Registration Statement in any state where we have undertaken or agreed to undertake such registration or qualification on an investor s behalf. We will not be liable to the extent any loss, claim or damage or liability arises out of or is based upon an untrue statement made in conformity with information provided by such investor in writing for use in this Registration Statement.

Company s Intention and Ability to Satisfy its Obligations to Selling Stockholders

We have the intention, and a reasonable basis to believe, we will have the financial ability to make payments on the outstanding Notes and Warrants, both in cash and shares of our common stock, if any. We have duly accounted for such payments as part of our strategic plan.

Existing Short Positions by Selling Stockholders

Based upon information provided by the selling stockholders, we have a reasonable belief no selling stockholders currently have a short position in our common stock.

Relationships and Arrangement with Selling Stockholders, Affiliates and Parties with Whom Any Selling Stockholders Have Contractual Relationships

As of April 3, 2009, in addition to the information provided in the Prospectus Summary of the Transaction, in the past three years, we have had the following relationships or arrangements with the selling stockholders, affiliates of a selling stockholder, or any person with whom any selling stockholder has a contractual relationship regarding the June 25, 2008 transaction:

On April 13, 2006, we entered into a Purchase Agreement with institutional and other accredited investors pursuant to which we sold an aggregate of 338,000 shares of our common stock at a price of $6.25 per share. One of these investors, Joel Pitlor, is also a member of our board of directors. Mr. Pitlor purchased 80,000 shares in the April 2006 private placement. As part of the April 2006 private placement, we agreed with the investors, including Mr. Pitlor, to file a registration statement with the SEC within ten days after the closing of the private placement to register the resale of the shares of common stock. We also agreed to keep the registration statement effective until the earlier of (i) two years after the date of the closing date, (ii) the date on which the shares may be resold by the purchasers without registration by reason of Rule 144 under the Securities Act of 1933 or any other rule of similar effect, or (iii) such time as all shares purchased by such stockholders have been sold. The Registration Statement covering the shares issued in the April 2006 private placement was declared effective by the SEC on August 14, 2006.

Method for Determining the Number of Shares Being Registered Hereunder

As negotiated among us and the investors, pursuant to terms of the transaction documents entered into by the parties to the June 25, 2008 financing and the February 1, 2007 financing, we are registering the exact number of:

- All shares issuable upon the conversion of an aggregate of $600,000 principal amount of the Notes issued in the June 25, 2008 financing transaction. The Notes are convertible at a rate of $1.25 and therefore we must register an aggregate of 480,000 shares underlying these Notes.

- An aggregate of 316,800 shares of common stock issuable upon the exercise of warrants issued in the June 25, 2008 financing transaction.

- An aggregate of 181,821 shares of common stock issuable upon the exercise of warrants issued in the February 1, 2007 private placement. Initially, 400,000 shares underlying these warrants were registered in a registration statement that was declared effective by the SEC on March 23, 2007. The warrants had an initial exercise price of $8.00 per share. Pursuant to the terms of the warrant agreement, if we issue convertible securities or warrants with an exercise price less than the current exercise price of the warrants issued in the February 1, 2007 private placement, we are required to adjust the exercise price accordingly. As a result of the June 25, 2008 transaction, the exercise price of the February 1, 2007 warrants was reduced from $8.00 to $5.50 per share. In addition, pursuant to the warrant agreement, upon any adjustment to the exercise price, the number of shares issuable upon exercise of the warrants must also be adjusted by multiplying such number by a fraction, the numerator of which is the exercise price immediately prior to the adjustment ($8.00 per share) and the denominator of which is the exercise price immediately after the adjustment ($5.50 per share). Therefore, we multiplied the number of shares that could be acquired by each holder by $8.00/$5.50, or 1.45455. The following table demonstrates how we determined the number of additional shares to register in the current registration statement:

Selling Stockholder	**Number of common shares underlying warrants issued on February 1, 2007 and registered in a previous registration statement**	**Total number of common shares underlying warrants issued on February 1, 2007, as adjusted for anti-dilution triggered by June 25, 2008 transaction (1)**	**Number of shares to be included on subsequent registration statement pursuant to Registration Rights Agreement, dated February 1, 2007 (2)**
Special Situations Fund III QP, L.P.	160,000	232,728	72,728
Special Situations Private Equity Fund, L.P.	160,000	232,728	72,728
Arnold Schumsky	24,000	34,910	10,910
Joel Pitlor	40,000	58,182	18,182
LaPlace Group LLC	16,000	23,273	7,273
TOTAL	***400,000***	***581,821***	***181,821***

All amounts included in the above table have been retroactively adjusted to reflect a 1 for 25 reverse stock split, effective December 11, 2008.

(1) Determined by multiplying the number of shares underlying the February 1, 2007 private placement warrants by 1.45455. Fractional amounts are rounded to the nearest whole share.

(2) Determined by subtracting the number of shares underlying warrants issued on February 1, 2007 from the total shares issuable upon exercise of the warrants, as adjusted for anti-dilution triggered on June 25, 2008.

Mr. Pitlor, our Director, has agreed to waive his registration rights as they pertain to this Registration Statement.

PLAN OF DISTRIBUTION

The selling stockholders, which as used herein includes donees, pledgees, transferees or other successors-in-interest selling shares of common stock or interests in shares of common stock received after the date of this prospectus from a selling stockholder as a gift, pledge, partnership distribution or other transfer, may, from time to time, sell, transfer or otherwise dispose of any or all of their shares of common stock or interests in shares of common stock on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These dispositions may be at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market price, at varying prices determined at the time of sale, or at negotiated prices.

The selling stockholders will act independently of us in making decisions with respect to the timing, manner and size of each sale. The selling stockholders may use any one or more of the following methods when disposing of shares or interests therein:

- ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;
- block trades in which the broker-dealer will attempt to sell the shares as agent, but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker-dealer as principal and resale by the broker-dealer for its account;
- an exchange distribution in accordance with the rules of the applicable exchange;
- privately negotiated transactions;
- short sales effected after the date the registration statement, of which this prospectus is a part, is declared effective by the SEC;
- through the writing or settlement of options or other hedging transactions, whether through an options exchange or otherwise;
- broker-dealers may agree with the selling stockholders to sell a specified number of such shares at a stipulated price per share;

- a combination of any such methods of sale; or
- any other method permitted by law.

The selling stockholders may, from time to time, pledge or grant a security interest in some or all of the shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock, from time to time, under this prospectus, or under an amendment to this prospectus under Rule 424(b)(3) or other applicable provision of the Securities Act of 1933 amending the list of selling stockholders to include the pledgee, transferee or other successors in interest as selling stockholders under this prospectus. The selling stockholders also may transfer the shares of common stock in other circumstances, in which case the transferees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus.

In connection with the sale of our common stock or interests therein, the selling stockholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the common stock in the course of hedging the positions they assume. The selling stockholders may also sell shares of our common stock short and deliver these securities to close out their short positions, or loan or pledge the common stock to broker-dealers that in turn may sell these securities. The selling stockholders may also enter into option or other transactions with broker-dealers or other financial institutions or the creation of one or more derivative securities which require the delivery to such broker-dealer or other financial institution of shares offered by this prospectus, which shares such broker-dealer or other financial institution may resell pursuant to this prospectus (as supplemented or amended to reflect such transaction).

The aggregate proceeds to the selling stockholders from the sale of the common stock offered by them will be the purchase price of the common stock less discounts or commissions, if any. Each of the selling stockholders reserves the right to accept and, together with their agents from time to time, to reject, in whole or in part, any proposed purchase of common stock to be made directly or through agents. We will not receive any of the proceeds from this offering. Upon any exercise of the warrants by payment of cash, however, we will receive the exercise price of the warrants.

The selling stockholders also may resell all or a portion of the shares in open market transactions in reliance upon Rule 144 under the Securities Act, provided that they meet the criteria and conform to the requirements of that rule.

Table of Contents

The selling stockholders and any underwriters, broker-dealers or agents that participate in the sale of the common stock or interests therein may be underwriters within the meaning of Section 2(11) of the Securities Act. Any discounts, commissions, concessions or profit they earn on any resale of the shares may be underwriting discounts and commissions under the Securities Act. Selling stockholders who are underwriters within the meaning of Section 2(11) of the Securities Act will be subject to the prospectus delivery requirements of the Securities Act.

To the extent required, the shares of our common stock to be sold, the names of the selling stockholders, the respective purchase prices and public offering prices, the names of any agents, dealer or underwriter, any applicable commissions or discounts with respect to a particular offer will be set forth in an accompanying prospectus supplement or, if appropriate, a post-effective amendment to the registration statement that includes this prospectus.

In order to comply with the securities laws of some states, if applicable, the common stock may be sold in these jurisdictions only through registered or licensed brokers or dealers. In addition, in some states the common stock may not be sold unless it has been registered or qualified for sale or an exemption from registration or qualification requirements is available and is complied with.

We have advised the selling stockholders that the anti-manipulation rules of Regulation M under the Exchange Act may apply to sales of shares in the market and to the activities of the selling stockholders and their affiliates. In addition, to the extent applicable we will make copies of this prospectus (as it may be supplemented or amended from time to time) available to the selling stockholders for the purpose of satisfying the prospectus delivery requirements of the Securities Act. The selling stockholders may indemnify any broker-dealer that participates in transactions involving the sale of the shares against certain liabilities, including liabilities arising under the Securities Act.

We have agreed to indemnify the selling stockholders against liabilities, including liabilities under the Securities Act and state securities laws, relating to the registration of the shares offered by this prospectus.

We have agreed with the selling stockholders to keep the registration statement of which this prospectus constitutes a part effective until the earlier of (i) such time as all of the shares covered by this prospectus have been disposed of pursuant to and in accordance with the registration statement, or (ii) the date on which the shares may be sold without restriction pursuant to Rule 144 of the Securities Act.

DESCRIPTION OF SECURITIES TO BE REGISTERED

The following description of our capital stock and provisions of our Articles of Organization and By-laws, each as amended, is only a summary. You should also refer to our Articles of Organization, a copy of which is incorporated by reference as an exhibit to the registration statement of which this prospectus is a part, and our By-laws, a copy of which is incorporated by reference as an exhibit to the registration statement of which this prospectus is a part. Our authorized capital stock consists of 50,000,000 shares of common stock, par value $0.01 per share.

Holders of our common stock are entitled to one vote for each share held on all matters submitted to a vote of our stockholders. Holders of our common stock have no rights under our Articles of Organization or our By-laws regarding dividends unless and until dividends are declared by the board of directors, nor do they have any rights under our Articles of Organization or our By-laws regarding preemption rights. The outstanding shares of common stock are fully paid and non-assessable.

INTERESTS OF NAMED EXPERTS AND COUNSEL

No expert or counsel named in this prospectus as having prepared or certified any part of this prospectus or having given an opinion upon the validity of the securities being registered or upon other legal matters in connection with the registration or offering of the common stock was employed for such purpose on a contingency basis, or had, or is to receive, in connection with this offering, a substantial interest, direct or indirect, in us or any of our subsidiaries, nor was any such person connected with us or any of our subsidiaries as a promoter, managing or principal underwriter, voting trustee, director, officer, or employee.

Table of Contents

INFORMATION ABOUT THE COMPANY

DESCRIPTION OF BUSINESS

History

We incorporated in Massachusetts in December 1982 and have been publicly-owned since November 1990. References to our Company contained herein include our two wholly-owned subsidiaries, Precise Medical, Inc. and Wood s Precision Optics Corporation, Limited, except where the context otherwise requires.

Our Business

We have been a developer and manufacturer of advanced optical instruments since 1982. We design and produce high-quality medical instruments, optical thin film coatings, micro-optics with characteristic dimensions less than 1 millimeter, or mm, and other advanced optical systems. Our medical instrumentation line includes laparoscopes, arthroscopes and endocouplers and a line of world-class 3-D endoscopes for use in minimally invasive surgical procedures. We are registered to the ISO 9001:2000, ISO 13485:2003, and Canadian Medical Devices Conformity Assessment System, or CMDCAS, Quality Standards, and comply with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE marking of our medical products. Our website is www.poci.com. Information contained on our website does not constitute part of this prospectus.

Principal Products and Services and Methods of Distribution

Medical Products: Endoscopes and Image Couplers. Since 1982, we have manufactured medical products such as endoscopes, as well as image couplers, beamsplitters and adapters, all of which are used as accessories to endoscopes. We have developed and sold endoscopes incorporating various optical technologies for use in a variety of minimally invasive surgical and diagnostic procedures. Our current line of specialized endoscopes include arthroscopes, which are used in joint surgery, laryngoscopes, which are used in the diagnosis of diseases of the larynx, laparoscopes, which are used in abdominal surgery, ENT scopes, which are used for ear, nose and throat procedures, and stereo endoscopes and cameras, which are used in cardiac and general surgery and enable surgeons to visualize the surgical field in 3-D imagery.

We produce autoclavable endoscopes for various applications, which are CE mark certified for European use, and have been designed and tested to withstand sterilization by autoclave, which is sterilization in a superheated steam under pressure, as well as all other commonly used medical sterilization means. The major benefits of instruments that can be autoclaved include increased patient safety, quick turnaround, and elimination of hazardous sterilant and by-product materials, all of which provide increased value to the user compared to alternative sterilization methods.

Since 1985, we have developed, manufactured and sold a proprietary product line of instrumentation to couple endoscopes to video cameras. Included in this product line are imaging couplers. For example, the Series 200 Parfocal Zoom Couplers and the Series 950 Universal Couplers physically connect the endoscope to a video camera system and transmit the image viewed through the scope to the video camera. Our Series 800 Beamsplitters perform the same function while preserving for the viewer an eye port for direct, simultaneous viewing through the endoscope. These devices are sold primarily to endoscope and video camera manufacturers and suppliers for resale under our customers names. All of the image couplers and beamsplitters that we manufacture are approved for surgery-approved sterilization. We believe we are one of only a few manufacturers of autoclavable image couplers worldwide.

Medical Products: Next Generation Lenslock TM Endoscopes. We continue to develop and ship our next generation endoscopes that incorporate our leading proprietary Lenslock TM technology (patent pending). Since December 2005, we have shipped over 400 ENT endoscopes with diameter of 2.7 mm that incorporate Lenslock TM technology. We recently completed prototypes of our 4 mm Lenslock TM sinuscope, and 5 mm Lenslock TM laproscope, and are actively pursuing development of our new 4 mm Lenslock TM wide field arthroscope. We believe that Lenslock TM technology has advantages over competitive products due to the ease of manufacture and repair, superior image quality, significant cost effectiveness and quality of repair. Further, we believe that incorporating this into our endoscope product line could lead to increased sales of this product.

Medical Products: Sub-millimeter Optics and Endoscopes. Utilizing recently developed proprietary techniques, including patent pending micro-precision TM lens fabrication technology, we design and manufacture ultra-small lenses, prisms and assemblies with sizes as small as 0.2 mm. Assemblies range in complexity from the combination of two lens elements to entire imaging systems utilizing multiple micro-optical elements in combination with larger, conventional optics. Developments in medical procedures requiring minimally invasive visualization in very small spaces, in such specialties as spinal surgery, neurosurgery, cardiothoracic surgery, cardiology and pulmonology, have led to products requiring lenses and endoscopes as small as 0.2 millimeters in diameter.

Utilizing our proprietary technology, we currently manufacture a number of products with length and/or diameter less than 1 mm and are actively expanding our product line in this area.

Medical Products: Custom Design and Device Production. We design prototypes and manufacture custom optical medical products to satisfy our customers specific requirements. During fiscal year 2007, we completed development and began shipments of an advanced surgical visualization system to a significant new customer. We have received initial follow-on orders for delivery in fiscal year 2009. The size and extent of future follow-on orders will depend on market acceptance and other considerations.

Industrial Products. In addition to our medical products, we also sell components and assemblies such as image couplers and beamsplitters specially designed for industrial use, including the video-monitored examination of a variety of industrial cavities and interiors, as well as specialized borescopes for industrial applications. Utilizing micro-precision TM technology, we also design and manufacture sub-millimeter optical components and assemblies for industrial use.

Night Vision Optics. We continue to pursue a partnership effort for the proprietary development of a new class of color night vision devices including a new patent-pending eyepiece lens. With a second round of prototypes nearing completion, it is expected that the product incorporating our new night vision lenses will be evaluated by the U.S. government in the near future. We cannot control the timing of current evaluations and cannot therefore predict when, if ever, these night vision lenses might begin to generate revenue.

Optical System Design and Development Services. We are able to provide customers with advanced lens design, imaging analysis, optical system design, structural design and analysis, prototype production and evaluation, optics testing, and optical system assembly. Some of our efforts have led to optical system production business for our Company, and we believe our prototype development service may lead to new product production from time to time.

Competition and Markets

We sell our products in a highly competitive market and we compete for business with both foreign and domestic manufacturers. Many of our current competitors are larger and have substantially greater resources than we do. In addition, there is an ongoing risk that other domestic or foreign companies who do not currently service or manufacture products for our target markets, some with greater experience in the optics industry and greater financial resources than we have, may seek to produce products or services that compete directly with ours.

We believe that competition for sales of our medical products and services, which have been principally sold to medical device companies who incorporate our products into their systems, is based on performance and other technical features, as well as other factors, such as scheduling and reliability, in addition to competitive pricing. We market and sell our endoscopes to customers for incorporation into their own product lines and for resale under their own name. A number of domestic and foreign competitors also sell endoscopes to these customers and our share of the endoscope market is nominal. We believe that, while our resources are substantially more limited than those of our competitors, we can compete successfully in this market on the basis of product quality, price, delivery and innovation.

We currently sell our image couplers, beamsplitters and adapters to a market that consists of approximately 30 to 35 potential customers who manufacture and sell video cameras, endoscopes and video-endoscopy systems. In the past, we have been successful in marketing and selling our products to approximately two-thirds of these customers, and currently estimate that we maintain approximately 20% to 30% of the market share in these products. We plan to continue to focus our sales and marketing efforts in this area, and to work to increase our market share. However, a challenge we face is customers   own in-house capabilities to manufacture such products. We estimate that approximately 50% of the market demand for image couplers, beamsplitters and adapters is met by these   captive   facilities. In general, and despite in-house capacity, we believe that many customers continue to purchase products from us in order to devote their own technical resources to their primary products, such as cameras or endoscopes.

Marketing

In May 2006, we initiated efforts to update our sales and marketing activities. As part of these efforts, we generated new marketing materials for recently developed products, including a newly designed website, www.poci.com. Since initiating these efforts, we have taken a much more comprehensive view of trade show opportunities, targeting those with specific relevance to recently developed products. Coupled with the recently renewed efforts for select key trade show attendance by our Chief Scientific Officer as well as our overall sales and marketing staff, we believe we have a greater opportunity to reach and follow up a broader customer base than we have previously been able to achieve. These efforts have contributed to recent year-over-year revenue increases, and continue to generate prospects for our leading technologies including, Lenslock TM, micro-precision TM, and custom applications of our core optical capabilities. This includes renewed interest in some of our well-developed products such as our   classic   autoclavable endoscopes and endocouplers, as well as new applications with our micro (fiberoptic) endoscopes.

Table of Contents

International Business

We have had negligible direct export sales to date. However, our medical products have received the CE Mark Certification, which permits sales into the European marketplace. We may establish or use production facilities overseas to produce key components for our business, such as lenses. Since the 1990s we have maintained a Hong Kong subsidiary to support business and quality control activities as required throughout Asia. We believe that the cost savings from such production may be essential to our ability to compete on a price basis in the medical products area particularly and to our profitability generally.

Research and Development

We believe that our future success depends to a large degree on our ability to continue to conceive and develop new optical products and services to enhance the performance characteristics and methods of manufacture of existing products. Accordingly, we expect to continue to seek to obtain product-related design and development contracts with customers and to invest our own funds on research and development. We spent $757,852 and $1,312,240 of our own funds, net of reimbursements, during fiscal years 2008 and 2007, respectively, on research and development.

We are currently incorporating our Lenslock TM technology (patent pending) into our line of endoscopes. This proprietary technology ensures lower cost, easier reparability and enhanced durability. We are also aggressively pursuing the design, development and manufacture of ultra-small instruments, some with lenses less than one millimeter in diameter, utilizing its micro-precision TM lens technology (patent pending).

Raw Materials and Principal Suppliers

The basic raw material of the majority of our product line is precision grade optical glass, which we obtain from a few suppliers, principally Schott and Ohara. For optical thin film coatings, the basic raw materials we utilize are metals and dielectric compounds, which we obtain from a variety of chemical suppliers. Certain of the thin film coatings utilized in our products are currently procured from an outside supplier, but most thin film coatings are produced in-house. We believe that our demand for these raw materials and thin film coating services is small relative to the total supply, and that the materials and services required for the production of our products are currently available in sufficient production quantities and will be available for fiscal year 2009. We believe, however, that there are relatively few suppliers of the high quality lenses and prisms, which our endoscopes require. In response, we have established our own optical shop for producing ultra-high quality prisms, micro-optics and other specialized optics for a variety of medical and industrial applications.

Patents and Trademarks

We rely, in part, upon patents, trade secrets and proprietary knowledge as well as personnel policies and employee confidentiality agreements concerning inventions and other creative efforts to develop and to maintain our competitive position. We do not believe that our business is dependent upon any patent, patent pending or license, although we believe that trade secrets and confidential know-how may be important to our scientific and commercial success.

We plan to file for patents, copyrights and trademarks in the United States and in appropriate countries to protect our intellectual property rights to the extent practicable. We hold the rights to several United States and foreign patents and have several patent applications pending, including those for our new generation of 3-D endoscopes, our Lenslock TM endoscope technology and our innovative micro-precision TM lens technology. These patents have expiration dates ranging from June 2009 to June 2028. We are not aware of any infringements of our patents. We plan to protect our patents from infringement in each instance where we determine that doing so would be economical in light of the expense involved and the level and availability of our financial resources. While we believe that our pending applications relate to patentable devices or concepts, these patents may not be issued and we may not be able to successfully defend these patents or effectively limit the development of competitive products and services.

Employees

As of April 3, 2009, we had 19 full-time employees and 8 part-time employees. There were 15 employees in manufacturing, 6 in engineering/research and development, 1 in sales and marketing and 5 in finance and administration. We are not a party to any collective bargaining agreements. We believe our relations with our employees are good.

Customers

Revenues from our largest customers, as a percentage of total revenues, for fiscal years 2008 and 2007 were as follows:

	2008	2007
Customer A	25%	27%
Customer B	20	22
Customer C	11	10
All Others	44	41
	100%	100%

No other customer accounted for more than 10% of our revenues in fiscal years 2008 and 2007. At June 30, 2008, receivables from our largest customers were 27%, 25% and 17% of the total accounts receivable.

Environmental Matters

Our operations are subject to a variety of federal, state and local laws and regulations relating to the discharge of materials into the environment or otherwise relative to the protection of the environment. From time to time, we use a small amount of hazardous materials in our operations. We believe that we comply with all applicable environmental laws and regulations.

Government Regulations on the Business

Domestic Regulation. We currently develop, manufacture and sell several medical products, the marketing of which is subject to governmental regulation in the United States. Medical devices are regulated in the United States by the Food and Drug Administration, or FDA, and, in some cases, by certain state agencies. The FDA regulates the research, testing, manufacture, safety, effectiveness, labeling, promotion and distribution of medical devices in the United States. Generally, medical devices require clearance or approval prior to commercial distribution. Additionally, certain material changes to, and changes in intended use of, medical devices also are subject to FDA review and clearance or approval. Non-compliance with applicable requirements can result in failure of the FDA to grant pre-market clearance or approval, withdrawal or suspension of approval, suspension of production, or the imposition of various other penalties.

We notified the FDA of our intent to market our endoscopes, image couplers, beamsplitters, adapters and video ophthalmoscopes, and the FDA has determined that we may market such devices, subject to the general controls provisions of the Food, Drug and Cosmetic Act. We obtained this FDA permission without the need to undergo a lengthy and expensive approval process due to the FDA s determination that such devices meet the regulatory standard of being substantially equivalent to an existing approved device.

In the future, we plan to market additional endoscopes and related medical products that may require the FDA s permission to market such products. We may also develop additional products or seek to sell some of our current or future medical products in a manner that requires us to obtain the permission of the FDA to market such products, as well as the regulatory approval or license of other federal, state and local agencies or similar agencies in other countries. The FDA has authority to conduct detailed inspections of manufacturing plants in order to assure that good manufacturing practices are being followed in the manufacture of medical devices, to require periodic reporting of product defects to the FDA and to prohibit the sale of devices which do not comply with law.

Foreign Requirements. Sales of medical device products outside the United States are subject to foreign regulatory requirements that may vary from country to country. Our failure to comply with foreign regulatory requirements would jeopardize our ability to market our products in foreign jurisdictions. The regulatory environment in the European Union for medical device products differs from that in the United States. Medical devices sold in the European Economic Area must bear the CE mark. Devices are classified by manufacturers according to the risks they represent, with a classification of Class III representing the highest risk devices and Class I representing the lowest risk devices. Once a device has been classified, the manufacturer can follow one of a series of conformity assessment routes, typically through a registered quality system, and demonstrate compliance to a European Notified Body. The CE mark may then be applied to the device. Maintenance of the system is ensured through annual on-site audits by the notified body and a post-market surveillance system requiring the manufacturer to submit serious complaints to the appropriate governmental authority. All of our medical products are CE mark certified.

DESCRIPTION OF PROPERTY

We conduct our domestic operations at two facilities in Gardner, Massachusetts. The main Gardner facility is leased from a corporation owned by an individual who is one of our officers and serves on our board of directors. The lease terminated in December 1999 and we are currently a tenant-at-will. We rent the other Gardner facility on a month-to-month basis. We rent office space in Hong Kong for sales, marketing and supplier quality control and liaison activities of our Hong Kong subsidiary.

Table of Contents

We believe these facilities are adequate for our current operations and adequately covered by insurance. Significant increases in production or the addition of significant equipment additions or manufacturing capabilities in connection with the production of our line of endoscopes, optical thin films and other products may; however, require the acquisition or lease of additional facilities. We may establish production facilities domestically or overseas to produce key assemblies or components, such as lenses, for our products. Overseas facilities may subject us to the political and economic risks associated with overseas operations. The loss of or inability to establish or maintain such additional domestic or overseas facilities could materially adversely affect our competitive position and profitability.

LEGAL PROCEEDINGS

We may be involved from time to time in ordinary litigation, negotiation and settlement matters that will not have a material effect on our operations or finances. We are not aware of any pending or threatened litigation against us or our officers and directors in their capacity as such that could have a material impact on our operations or finances.

MARKET PRICE OF AND DIVIDENDS ON COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

Our common stock is quoted on the Over-The-Counter Bulletin Board, or OTCBB, under the symbol PEYE.OB. The following table sets forth the high and low bid prices for our common stock for each quarter during the last two fiscal years and the subsequent interim period as quoted on the OTCBB. Such OTCBB market quotations reflect inter-dealer prices, without retail markup, markdown or commissions and may not necessarily represent actual transactions. All prices have been adjusted to reflect a 1 for 25 reverse stock split, effective December 11, 2008.

	High	Low
For the Fiscal Year Ended June 30, 2009		
First Quarter ended September 30, 2008	$ 3.25	$ 1.00
Second Quarter ended December 31, 2008	$ 2.25	$ 0.10
Third Quarter ended March 31, 2009	$ 1.01	$ 0.16
For the Fiscal Year Ended June 30, 2008		
First Quarter ended September 30, 2007	$ 10.00	$ 5.00
Second Quarter ended December 31, 2007	$ 8.75	$ 3.00
Third Quarter ended March 31, 2008	$ 6.00	$ 2.75
Fourth Quarter ended June 30, 2008	$ 5.00	$ 2.50
For the Fiscal Year Ended June 30, 2007		
First Quarter ended September 30, 2006	$ 12.25	$ 6.25
Second Quarter ended December 31, 2006	$ 12.25	$ 6.25
Third Quarter ended March 31, 2007	$ 15.00	$ 8.00
Fourth Quarter ended June 30, 2007	$ 12.50	$ 8.00

Holders

As of April 3, 2009, we had approximately 81 holders of record of our common stock. Holders of record include nominees who may hold shares on behalf of multiple owners.

Dividends

We have not declared any dividends during the last two fiscal years and through the quarter ended March 31, 2009. At present, we intend to retain our earnings, if any, to finance research and development and expansion of our business.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information as of June 30, 2008, regarding our compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance. Information set forth herein gives effect to a 1 for 25 reverse stock split on December 11, 2008.

Table of Contents

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)		Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	97,232	$	15.75	137,098
Equity compensation plans not approved by security holders				
Total	97,232	$	15.75	137,098

Table of Contents

FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Precision Optics Corporation, Inc.:

We have audited the accompanying consolidated balance sheets of Precision Optics Corporation, Inc. and subsidiaries (the Company) as of June 30, 2008 and the related consolidated statements of operations, stockholders equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audit 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 controls over financial reporting. An audit includes 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2008 and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring net losses and negative cash flows from operations, which raises substantial doubt about its ability to continue as a going concern. Management s plans concerning these matters are described in Note 1. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Stowe & Degon

Leominster, Massachusetts

September 23, 2008 except with respect to the stock split discussed in Note 9 as to which the date is December 15, 2008

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Precision Optics Corporation, Inc.:

We have audited the accompanying consolidated balance sheet of Precision Optics Corporation, Inc. and subsidiaries (the Company) as of June 30, 2007 and the related consolidated statements of operations, stockholders   equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit 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 controls over financial reporting. An audit includes 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2007 and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 of the notes to the consolidated financial statements, effective July 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment.*

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring net losses and negative cash flows from operations, which raises substantial doubt about its ability to continue as a going concern. Management s plans concerning these matters are described in Note 1. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Vitale, Caturano & Company, P.C.

VITALE, CATURANO & COMPANY, P.C.

Boston, Massachusetts

September 26, 2007 (except with respect

to the reverse stock split discussed in Note 9

as to which the date is December 15, 2008)

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets at June 30, 2008 and 2007

		2008		2007
ASSETS				
Current Assets:				
Cash and cash equivalents	$	885,988	$	840,179
Accounts receivable (net of allowance for doubtful accounts of approximately $7,400 and $11,159 in 2008 and 2007, respectively)		387,224		801,206
Inventories		608,431		904,736
Prepaid expenses		36,749		53,039
Total current assets		1,918,392		2,599,160
Fixed Assets:				
Machinery and equipment		2,352,634		3,559,384
Leasehold improvements		553,596		553,596
Furniture and fixtures		149,738		150,603
Vehicles		42,343		42,343
		3,098,311		4,305,926
Less Accumulated depreciation and amortization		2,935,922		4,148,239
Net fixed assets		162,389		157,687
Other Assets:				
Cash surrender value of life insurance policies		5,465		4,438
Patents, net		195,391		274,311
Total other assets		200,856		278,749
	$	2,281,637	$	3,035,597
LIABILITIES AND STOCKHOLDERS EQUITY				
Current Liabilities:				
Accounts payable	$	364,409	$	343,730
Customer advances		91,105		2,690
Accrued employee compensation		293,497		270,437
Accrued professional services		94,312		75,616
Accrued warranty expense		25,000		25,000
Other accrued liabilities		912		914
Total current liabilities		869,235		718,387
10% Senior secured convertible notes		10,304		
Commitments (Note 3)				
Stockholders Equity:				
Common stock, $0.01 par value-Authorized 50,000,000 shares Issued and outstanding 1,018,411 shares at June 30, 2008 and June 30, 2007		10,184		10,184
Additional paid-in capital		38,149,655		37,441,413
Accumulated deficit		(36,757,741)		(35,134,387)
Total stockholders equity		1,402,098		2,317,210

	$	2,281,637	$	3,035,597

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Operations for the

Years Ended June 30, 2008 and 2007

		2008		**2007**
Revenues	$	2,902,219	$	2,477,469
Cost of Goods Sold		2,110,217		2,002,196
Gross profit		792,002		475,273
Research and Development Expenses, net		757,852		1,312,240
Selling, General and Administrative Expenses		1,867,093		2,097,959
Gain on Sale of Product Line		(210,549)		
Total operating expenses		2,414,396		3,410,199
Operating loss		(1,622,394)		(2,934,926)
Interest Income (Expense), net		(48)		46,011
Loss before provision for income taxes		(1,622,442)		(2,888,915)
Provision for Income Taxes		912		914
Net loss	$	(1,623,354)	$	(2,889,829)
Loss per Share - Basic and Diluted	$	(1.59)	$	(3.68)
Weighted Average Common Shares Outstanding - Basic and Diluted		1,018,411		784,995

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

for the Years Ended June 30, 2008 and 2007

	Number of Shares		Common Stock		Additional Paid-in Capital		Accumulated Deficit		Total Stockholders Equity
Balance, June 30, 2006	618,411	$	6,184	$	34,878,271	$	(32,244,558)	$	2,639,897
Proceeds from sale of common stock and warrants, net	400,000		4,000		2,372,216				2,376,216
Stock-based compensation					190,926				190,926
Net loss							(2,889,829)		(2,889,829)
Balance, June 30, 2007	1,018,411	$	10,184	$	37,441,413	$	(35,134,387)	$	2,317,210
Proceeds from issuance of senior convertible notes and warrants allocated to warrants					399,000				399,000
Proceeds from issuance of senior convertible notes and warrants allocated to beneficial conversion feature					201,000				201,000
Stock-based compensation					108,242				108,242
Net loss							(1,623,354)		(1,623,354)
Balance, June 30, 2008	1,018,411	$	10,184	$	38,149,655	$	(36,757,741)	$	1,402,098

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows for the

Years Ended June 30, 2008 and 2007

		2008		**2007**
Cash Flows from Operating Activities:				
Net loss	$	(1,623,354)	$	(2,889,829)
Adjustments to reconcile net loss to net cash used in operating activities- Depreciation and amortization		161,169		120,404
Gain on sale of product line		(210,549)		
Provision for inventory write-down		39,059		31,100
Stock-based compensation expense		108,242		190,926
Non-cash interest expense		10,304		
Changes in operating assets and liabilities-				
Accounts receivable, net		413,982		(420,109)
Inventories		237,141		(490,034)
Prepaid expenses		16,290		(7,127)
Accounts payable		20,679		125,072
Customer advances		88,415		2,690
Accrued expenses		41,754		1,989
Net cash used in operating activities		(696,868)		(3,334,918)
Cash Flows from Investing Activities:				
Purchases of property and equipment		(58,718)		(139,667)
Proceeds from sale of product line		250,000		
Product line sale costs		(19,051)		
Increase in other assets		(29,554)		(91,880)
Net cash provided by (used in) investing activities		142,677		(231,547)
Cash Flows from Financing Activities:				
Proceeds from issuance of senior convertible notes and warrants		600,000		
Gross proceeds from private placement				2,500,000
Payment of offering costs				(123,784)
Net cash provided by financing activities		600,000		2,376,216
Net increase (decrease) in cash and cash equivalents		45,809		(1,190,249)
Cash and cash equivalents, beginning of year		840,179		2,030,428
Cash and cash equivalents, end of year	$	885,988	$	840,179
Supplemental Disclosure of Cash Flow Information:				
Cash paid during the year for- Income taxes	$	912	$	914
Supplemental Disclosure of Non-Cash Investing and Financing Activities:				
Cost of inventory sold as part of product line disposal	$	20,105	$	

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Nature of Business and Liquidity

Precision Optics Corporation, Inc. (the Company) designs, develops, manufactures and sells specialized optical systems and components and optical thin-film coatings. The Company conducts business in one industry segment only and its customers are primarily domestic. The Company s products and services fall into two principal areas: (i) medical products for use by hospitals and physicians; and (ii) advanced optical system design and development services and products used by industrial customers.

The Company has sustained recurring net losses and negative cash flows from operations for several years. During the year ended June 30, 2008, the Company incurred a net loss of $1,623,354 and used cash in operations of $696,868. As of June 30, 2008, cash and cash equivalents were $885,988, accounts receivable were $387,224 and current liabilities were $869,235, resulting in a net liquid asset amount of $403,977. These factors raise substantial doubt about the Company s ability to continue as a going concern. The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. During the latter part of fiscal year 2008, the Company implemented plans to reduce costs and to streamline operations in an effort to reduce net losses. This has resulted in an increase in gross profit and simultaneous decreases in operating expenses, thereby reducing losses substantially, particularly in the third and fourth quarters of fiscal year 2008. The Company believes that the recent introduction of several new products, along with new and on-going customer relationships, will generate additional revenues, which are required in order for the Company to achieve profitability. If these additional revenues are not achieved on a timely basis, the Company will be required and is prepared to implement further cost reduction measures, as necessary.

The Company has incurred quarter to quarter operating losses during its recent efforts to develop current products including endoscopes, image couplers, beamsplitters, thin film coatings, night vision and micro-optic lenses, prisms and assemblies for various applications and utilizing a number of proprietary and patent-pending technologies including Lenslock TM endoscope and micro-precision TM lens technologies. Management expects that such operating losses will continue through fiscal year 2009, and until sales increase to breakeven and profitable levels. Management also believes that the opportunities represented by these products have the potential to generate sales increases to achieve breakeven and profitable results. The Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved. There can be no assurance that the Company s operating plans will be successful, and if so required, that the Company will be successful in obtaining the capital necessary to continue ongoing operations.

In April 2006, the Company completed a private placement, issuing 338,000 shares of common stock. Net cash proceeds to the Company (after offering costs of $49,725) were $2,062,775. In February 2007, the Company completed a private placement, pursuant to which it sold an aggregate of 400,000 shares of common stock and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of

$8.00 per share. Net cash proceeds to the Company (after offering costs of $123,784) were $2,376,216 (see Note 4). In June 2008, the Company issued senior secured convertible notes and warrants, raising cash proceeds of $600,000.

During the past year, the introduction of several new products, along with new and on-going customer relationships, has resulted in significant revenue growth. The Company believes that with continued promotion, these opportunities have the potential to continue the general trend of increasing revenues, which, along with enhanced operations are required in order for the Company to achieve profitability.

(b) Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its two wholly owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation. All shares and per share data reflect the effects of a 1-for-25 reverse stock split that became effective on December 11, 2008.

(c) Revenues

The Company recognized revenue in accordance with Securities and Exchange Commission issued Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB No. 104), which requires that four basic criteria must be met before revenue can be recognized:

Table of Contents

(1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed and determinable; and (4) collectability is reasonably assured. The Company s shipping terms are customarily FOB shipping point. The Company s revenue recognition practices comply with the guidance in the bulletin.

The sales price of products and services sold is fixed and determinable after receipt and acceptance of a customer s purchase order or properly executed sales contract, typically before any work is performed. Management reviews each customer purchase order or sales contract to determine that the work to be performed is specified and there are no unusual terms and conditions that would raise questions as to whether the sales price is fixed or determinable. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. Accounts receivable are stated at the amount management expects to collect from outstanding balances. An allowance for doubtful accounts is provided for that portion of accounts receivable considered to be uncollectible, based upon historical experience and management s evaluation of outstanding accounts receivable at the end of the year. Bad debts are written off against the allowance when identified.

The Company s revenue transactions typically do not contain multiple deliverable elements for future performance obligations to customers, other than a standard one-year warranty on materials and workmanship, the estimated costs for which are provided for at the time revenue is recognized.

Revenues for industrial and medical products sold in the normal course of business are recognized upon shipment when delivery terms are FOB shipping point and all other revenue recognition criteria have been met. Gross shipping charges reimbursable from customers, to deliver product, are insignificant and are included in Revenues, while shipping costs are classified as the Selling, General and Administrative Expenses section of the Consolidated Statement of Operations.

(d) Cash and Cash Equivalents

The Company includes in cash equivalents all highly liquid investments with original maturities of three months or less at the time of acquisition. Cash and cash equivalents of $885,988 and $840,179 at June 30, 2008 and 2007, respectively, consist primarily of cash at banks and money market funds. The Company maintains its cash and cash equivalents in bank deposit accounts that, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

(e) Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. The components of inventories at June 30, 2008 and 2007 are as follows:

	2008	**2007**

Raw material	$	347,298	$	511,588
Work-in-progress		177,464		349,936
Finished goods		83,669		43,212
	$	608,431	$	904,736

The Company provides for estimated obsolescence on unmarketable inventory based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Inventory, once written down, is not subsequently written back up, as these adjustments are considered permanent adjustments to the carrying value of the inventory.

During fiscal years 2008 and 2007, the Company recorded pre-tax non-cash provisions for slow-moving and obsolete inventories of approximately $39,000 and $31,100, respectively.

(f) Property and Equipment

Property and equipment are recorded at cost. Maintenance and repair items are expensed as incurred. The Company provides for depreciation and amortization by charges to operations, using the straight-line and declining-balance methods, which allocate the cost of property and equipment over the following estimated useful lives:

Asset Classification	**Estimated Useful Life**
Machinery and equipment	2-7 years
Leasehold improvements	Shorter of lease term or estimated useful life
Furniture and fixtures	5 years
Vehicles	3 years

Amortization of assets under capital leases is included in depreciation expense. Depreciation expense was $53,720 and $57,911 for the years ended June 30, 2008 and 2007, respectively.

(g) Significant Customers and Concentration of Credit Risk

Statement of Financial Accounting Standards (SFAS) No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* requires disclosure of any significant off-balance sheet and credit risk.

Financial instruments that subject the Company to credit risk consist primarily of cash equivalents and trade accounts receivable. The Company places its investments with highly rated financial institutions. The Company has not experienced any losses on these investments to date. At June 30, 2008, receivables from the Company s largest customers were 27%, 25% and 17% of the total accounts receivable. At June 30, 2007, receivables from the Company s largest customer were 61% of the total accounts receivable. No other customer accounted for more than 10% of the Company s receivables as of June 30, 2008 and 2007. The Company has not experienced any material losses related to accounts receivable from individual customers. The Company generally does not require collateral or other security as a condition of sale rather relying on credit approval, balance limitation and monitoring procedures to control credit risk of trade account financial instruments. Management believes that allowances for doubtful accounts, which are established based upon review of specific account balances and historical experience, are adequate.

Revenues from the Company s largest customers, as a percentage of total revenues, were as follows:

	2008	**2007**
Customer A	25%	27%
Customer B	20	22
Customer C	11	10
All Others	44	41
	100%	100%

No other customer accounted for more than 10% of the Company s revenues in fiscal years 2008 and 2007.

(h) Loss per Share

The Company calculates earnings per share according to SFAS No. 128, *Earnings per Share.* Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For each of the two years in the periods ended June 30, 2008 and 2007, the effect of stock options was anti-dilutive; therefore, they were not included in the computation of diluted loss per share. The number of shares issuable upon the exercise of outstanding stock options and warrants that were excluded from the computation, as their effect would be anti-dilutive, was approximately 996,066 and 501,303 during fiscal 2008 and 2007, respectively.

(i) Stock-Based Compensation

On July 1, 2006, the Company adopted SFAS No. 123(R), *Accounting for Stock-Based Compensation* (SFAS No. 123(R)), which requires the measurement and recognition of all compensation costs for all stock based awards made to employees and the Board of Directors based upon fair value over the requisite service period for awards expected to vest. Prior to adoption, the Company accounted for stock options under the intrinsic value method set in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations, and provided the required pro forma disclosures prescribed by SFAS No. 123, *Accounting for Share-based Compensation* (SFAS No. 123), as amended.

SFAS 123(R) requires the Company to estimate the fair value of share-based awards on the date of grant using an option-pricing model. The Company adopted SFAS 123(R) using the modified prospective transition method which required the application of the accounting standard starting July 1, 2006, the first day of the Company s fiscal year 2007. Prior period information has not been restated to reflect the fair value method of expensing share-based awards. Stock-based compensation costs recognized for the year ended June 30, 2008 and 2007 amounted to $108,242 and $190,926, respectively.

Table of Contents

(j) Foreign Currency Translation

The Company translates certain accounts and financial statements of its foreign subsidiary in accordance with SFAS No. 52, *Foreign Currency Translation.* The functional currency of the Company s foreign subsidiary is the United States dollar. Transaction gains or losses are reflected in the accompanying consolidated statements of operations and have not been significant.

(k) Patents

Patents are carried at cost, less accumulated amortization of $623,063 and $515,615 at June 30, 2008 and 2007, respectively. Such costs are amortized using the straight-line method over the shorter of their legal or estimated useful lives, generally five to ten years. Amortization expense was $107,448 and $62,493 for the years ended June 30, 2008 and 2007, respectively. Amortization expense is expected to be approximately $30,000, $28,000, $27,000, $26,000 and $25,000, respectively, for the years ending June 30, 2009 through June 30, 2013.

(l) Financial Instruments

SFAS No. 107, *Disclosure About Fair Value of Financial Instruments,* requires disclosures about the fair value of financial instruments. Financial instruments consist principally of cash equivalents, accounts receivable, accounts payable, and accrued expenses. The estimated fair value of these financial instruments approximates their carrying value due to the short-term nature of these financial instruments.

(m) Long-Lived Assets

The Company accounts for long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset 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 undiscounted net cash flows expected to be generated by the 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

(n) Warranty Costs

The Company does not incur future performance obligations in the normal course of business other than providing a standard one-year warranty on materials and workmanship to its customers. The Company provides for estimated warranty costs at the time product revenue is recognized. Warranty costs have been included as a component of cost of goods sold in the accompanying consolidated statements of operations. The following tables summarize warranty reserve activity for the two years ended June 30, 2008:

		2008		**2007**
Balance at beginning of period	$	25,000	$	50,000
Provision (credit) for warranty claims		2,619		(14,197)
Warranty claims incurred		(2,619)		(10,803)
Balance at end of period	$	25,000	$	25,000

(o) Research and Development

Research and development expenses are charged to operations as incurred. The Company groups development and prototype costs and related reimbursements in research and development. For the years ended June 30, 2008 and 2007, research and development expense is shown net of reimbursements of $224,107 and $101,309, respectively, in the accompanying statements of operations.

(p) Comprehensive Income

SFAS No. 130, *Reporting Comprehensive Income,* requires disclosure of all components of comprehensive income on an annual and interim basis. Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owners sources.

The Company s comprehensive loss for the years ended June 30, 2008 and 2007 was equal to its net loss for the same periods.

Table of Contents

(q) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the likelihood of utilization of existing deferred tax assets, management has considered historical results of operations and the current operating environment.

(r) Segment Reporting

SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information,* establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS No. 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions about how to allocate resources and assess performance. The Company s chief decision-maker, as defined under SFAS No. 131, is the Chief Executive Officer. To date, the Company has viewed its operations and manages its business as principally one segment. For all periods presented, over 90% of the Company s sales have been to customers in the United States.

(s) Use of Estimates

The preparation of financial statements in conformity with accounting standards generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(t) Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity s fiscal year that begins after December 15, 2008 (July 1, 2009 for the Company). The impact of this Statement on the Company s financial position, results of operations and cash flows will be dependent on the terms, conditions and details of such acquisitions.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159), which allows the Company to choose to measure selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 (July 1, 2008 for the Company). The Company is in the process of evaluating the impact of this authoritative guidance on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which provides a single definition of fair value, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement defined as the price that would be received to sell an asset or liability in an orderly transaction between market participants at the measurement date. Thus, SFAS No. 157 adheres to a definition of fair value based upon exit price as opposed to entry price (i.e. the price paid to acquire an asset or liability). This pronouncement is effective for fiscal years beginning after November 15, 2007 (July 1, 2008 for the Company). The Company is in the process of evaluating the impact of this authoritative guidance on its consolidated financial statements.

(2) 10% SENIOR SECURED CONVERTIBLE NOTES

On June 25, 2008, the Company entered into a Purchase Agreement with institutional and other accredited investors pursuant to which it sold an aggregate of $600,000 of 10% Senior Secured Convertible Notes, which are convertible into an aggregate of 480,000 shares of common stock, par value $0.01 per share, at a conversion price of $1.25 per share, and warrants to purchase an aggregate of

Table of Contents

316,800 shares of common stock at an exercise price of $1.75 per share. The Investors are current stockholders of the Company. Interest accrues on the Notes at a rate of 10% per annum and is payable upon the earlier of conversion or maturity of the Notes. The Notes mature on June 25, 2010, and the Warrants expire on June 25, 2015. The Notes and Warrants are not convertible or exercisable until the Company implements a reverse stock split, which requires the approval of its stockholders and the effectiveness of an amendment (the Amendment) to its Articles of Organization to effect the reverse stock split. The closing of the sale of the Notes and Warrants occurred on June 25, 2008.

The Purchase Agreement contains customary representations and warranties of the Company and the Investors, and the Notes contain customary covenants binding on the Company and customary events of default. If an event of default occurs and is uncured within the allowable grace period, if any, the Investors may declare all amounts under the Notes immediately due and payable and may pursue any other available remedies.

The Notes are secured by a pledge of the Company s assets under the terms of a Pledge and Security Agreement and the security documents ancillary thereto.

Pursuant to a Registration Rights Agreement entered into with the Investors on June 25, 2008, the Company has agreed to file a registration statement with the Securities and Exchange Commission by the earlier of (i) two days following the effectiveness of the Amendment or (ii) December 15, 2008, to register the resale of the common stock issuable upon the conversion of the Notes and the exercise of the Warrants. The Company has also agreed to use its commercially reasonable efforts to have the registration statement declared effective as soon as practicable after filing and has agreed to take certain other actions related to the effectiveness of the registration statement.

The 10% senior secured convertible notes consist of the following:

		June 30, 2008		June 30, 2007
10 % Senior Secured Convertible Notes issued on June 25, 2008, convertible into common stock at $1.25 per share, bearing interest at 10% per annum. Outstanding principal and accrued interest are due at maturity, June 25, 2010.	$	600,000	$	
Accrued interest 10% coupon		833		
Unamortized discount		(590,529)		
	$	10,304	$	

Upon issuance of the Notes and Warrants, the proceeds of $600,000 were allocated between the Notes and Warrants based on relative fair values. The value of the Warrants was recorded as a discount to the Notes, with a corresponding increase to additional paid-in capital. The fair value of the Warrants was determined using the Black-Scholes method, with the following assumptions:

Expected life	7 years
Risk-free rate	4.84%
Expected Dividends	0.00%

Volatility factor	154%

In accordance with EITF 00-27, *Application of EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,* the proceeds from the issuance of the 10% senior secured convertible notes were first allocated between the Notes and the Warrants. The value of the conversion feature was then calculated, which resulted in an effective conversion ratio that was less than the market price of the Company s common stock. The intrinsic value of this beneficial conversion feature was recorded as a further discount to the Notes, equal to the difference between the effective conversion ratio and the market price of the Company s common stock, with a corresponding increase to additional paid-in capital.

The following summarizes the discount on 10% senior secured convertible notes as of June 30:

		2008		**2007**
Discount beginning balance	$		$	
Proceeds allocated to warrants		399,000		
Beneficial conversion feature intrinsic value		201,000		
Less: amortization of discount		(9,471)		
Discount ending balance	$	590,529	$	

(3) COMMITMENTS

(a) Related Party Transactions

The Company leases one of its facilities from a corporation owned by an officer-director-shareholder of the Company. The Company is currently a tenant-at-will, paying rent of $9,000 per month. Total rent expense paid to related parties was $108,000 in each of fiscal years 2008 and 2007, and is included in the accompanying consolidated statements of operations.

The Company paid or accrued fees to a director of $60,000 in each of fiscal years 2008 and 2007 for consulting services.

Another director is a former partner in a law firm who has performed legal services for the Company during fiscal 2008 and 2007 totaling approximately $151,000 and $217,000, respectively. This director retired from his position as a member of the Board of Directors of the Company, effective at the close of business on June 28, 2007.

(b) Operating Lease Commitments

The Company has entered into operating leases for its office space and equipment that expire at various dates through fiscal year 2009. Total future minimum rental payments under all non-cancelable operating leases are approximately $33,800 in fiscal 2009 and $7,500 thereafter.

Rent expense on operating leases, excluding the related party rent described above, was approximately $46,900 and $47,500 for the years ended June 30, 2008 and 2007, respectively.

(4) STOCKHOLDERS EQUITY

(a) Stock Options

Stock-based compensation costs recognized for the year ended June 30, 2008 and 2007, included compensation costs for awards granted prior to, but not yet vested as of July 1, 2006 (adoption date), as well as any new grants issued after July 1, 2006. Total costs recognized during the year ended June 30, 2008 and 2007 amounted to $108,242 and $190,926, respectively, and were included in the accompanying consolidated statements of operations in: selling, general and administrative expenses (2008 - $83,161; 2007 - $164,831), cost of goods sold (2008 - $18,635; 2007 - $19,435), and research and development expenses, net (2008 - $6,446; 2007 - $6,660). No compensation has been capitalized because such amounts would have been immaterial. There was no net income tax benefit recognized related to such compensation for the years ended June 30, 2008 or 2007, as the Company is currently in a loss position. The total amount of options granted during the year ended June 30, 2008 was 1,200.

As of June 30, 2008, the unrecognized compensation costs related to options vesting will be primarily recognized over a period of approximately 3 years:

OPTIONS		**2009**		**2010**		**2011**		**TOTAL**
Compensation Expense	$	80,018	$	16,930	$	16,930	$	113,878

On November 10, 2005, the FASB issued FASB Staff Position SFAS 123R-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards.* The Company has elected to adopt the alternative transition method provided by the FASB Staff Position for calculating the tax effects (if any) of stock-based compensation expense pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee stock-based compensation, and to determine the subsequent impact to the additional paid-in capital pool and the consolidated statement of operation and cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

Upon adoption of SFAS 123(R), in accordance with Staff Accounting Bulletin No. 107, *Share-Based Payment*, the Company selected the Black-Scholes option-pricing model as the most appropriate method for determining the estimated fair value for the stock awards. The Black-Scholes method of valuation requires several assumptions: (1) the expected term of the stock award; (2) the expected future stock volatility over the expected term; and (3) risk-free interest rate. The expected term represents the expected period of time the Company believes the options will be outstanding based on historical information. Estimates of expected future stock price volatility are based on the historic volatility of the Company s common stock and the risk free interest rate is based on the U.S. Zero-Bond rate. The Company utilizes a forfeiture rate based on an analysis of the Company s actual experience. The fair value of options at date of grant was estimated with the following assumptions:

	Years Ended June 30, 2008	June 30, 2007
Assumptions:		
Option life	5.3 years	5.3 years
Risk-free interest rate	4.84%	4.67%
Stock volatility	147%	108%
Dividend yield	0	0
Weighted average fair value of grants	$ 0.29	$ 0.22

Stock Option and Other Compensation Plans:

The type of share-based payments currently utilized by the Company is stock options.

The Company has various stock option and other compensation plans for directors, officers, and employees. The Company has the following stock option plans outstanding as of June 30, 2008: Amended and Restated 1997 Incentive Plan and the 2006 Equity Incentive Plan. Vesting periods are at the discretion of the Board of Directors and typically average five years. Options under these plans are granted at fair market value and have a term of ten years from the date of grant.

During fiscal 2007, the stockholders approved an equity incentive plan (the 2006 Incentive Plan), which provides eligible participants (certain employees, directors, consultants, etc.) the opportunity to receive a broad variety of equity based and cash awards. Options granted vest and are exercisable for periods determined by the Board of Directors, not to exceed 10 years from the date of grant. A total of 139,898 shares of common stock have been reserved for issuance under the 2006 Incentive Plan. At June 30, 2008, a total of 2,800 stock options are outstanding and 137,098 shares of common stock were available for future grants under the 2006 Incentive Plan.

During fiscal 1998, the stockholders approved an incentive plan (the 1997 Incentive Plan), which provided eligible participants (certain employees, directors, consultants, etc.) the opportunity to receive a broad variety of equity based and cash awards. Options granted vest and are exercisable for periods determined by the Board of Directors, not to exceed 10 years from the date of grant. Options for a total of 94,432 shares of common stock are outstanding at June 30, 2008 under the 1997 Incentive Plan, as amended and restated in fiscal year 2006. Prior to the adoption of the 2006 Incentive Plan, 9,000 stock options were granted in fiscal year 2007 under the 1997 Incentive Plan. Upon the adoption of the 2006 Incentive Plan, no new awards were granted under the 1997 Plan. No shares are available for future grants under the Company s 1997 Stock Option Plan.

The following tables summarize stock option activity for the two years ended June 30, 2008:

		Options Outstanding	
	Number of Shares	Weighted Average Exercise Price	Weighted Average Contractual Life
Outstanding at June 30, 2006	91,135	$ 16.50	9.86 years

Grants	10,600		6.75	
Exercises				
Cancellations	(400)		13.75	
Outstanding at June 30, 2007	101,335	$	15.50	8.57 years
Grants	1,200		7.75	
Exercises				
Cancellations	(5,303)		9.00	
Outstanding at June 30, 2008	97,232	$	15.75	7.56 years

Information related to the stock options outstanding as of June 30, 2008 is as follows:

Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Exercisable Number of Shares	Exercisable Weighted-Average Exercise Price
$6.25	6,600	8.27	$ 6.25	3,267	$ 6.25
$7.75	1,200	9.42	7.75	1,200	7.75
$11.50	800	7.42	11.50	800	11.50
$13.75	51,272	7.86	13.75	39,996	13.75
$20.75	37,360		20.75	37,360	20.75
$6.25-$20.75	97,232	7.56	$ 15.75	82,623	$ 16.50

The aggregate intrinsic value of the Company s in-the-money outstanding and exercisable options as of June 30, 2008 was $0 and $0, respectively.

On June 13, 2005, the Company issued options to purchase 37,360 shares (Performance Options) of common stock at an exercise price of $20.75 per share. At the date of issuance, 30% of the options vested immediately, and the remaining options were subject to vesting upon the achievement of certain financial milestones by the Company. During fiscal 2007, certain of these milestones were met, and an additional 35% of the options vested as of July 31, 2007. During the first quarter of fiscal year 2008, the additional milestones were met, and the remaining 35% of the options vested on October 31, 2007.

(b) Sale of Stock

In February 2007, the Company completed a private placement with institutional and other accredited investors pursuant to which it sold an aggregate of 400,000 shares of common stock, at a price of $6.25 per share and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of $8.00 per share. In conjunction with the issuance by the Company of senior convertible notes and warrants on June 25, 2008, certain anti-dilution provisions of the existing warrants were triggered. As a result, the number of existing warrants was increased from 400,000 to 581,821 and the related exercise price was decreased from $8.00 per share to $5.50 per share. Net cash proceeds to the Company (after offering costs of $123,784) were $2,376,216. On March 16, 2007, in order to fulfill its contractual obligations, the Company filed a registration statement with the Securities and Exchange Commission, under the Securities Act of 1933, as amended, to register for resale the shares of common stock issued and the shares of common stock issuable upon the exercise of the warrants sold in this private placement. The Company s registration statement on Form SB-2 covering the securities sold in the private placement was declared effective on March 23, 2007. The Company is obligated to keep the registration statement effective until the earlier of (i) such time as all of the shares covered by the prospectus have been sold or (ii) the date on which the shares may be resold pursuant to Rule 144(k) of the Securities Act of 1933 (the Securities Act). Except in the event of adverse market conditions and certain permitted delays, if the Company fails to maintain the effectiveness of the prospectus then it will be required to pay liquidated damages to the holders of shares registered there under in an amount equal to 1.0% of the aggregate amount invested by such holder for each 30-day period or pro rata for any portion thereof following the date by which such prospectus should have been effective.

In April 2006, the Company completed a private placement, issuing 338,000 shares of common stock. Net cash proceeds (after offering costs of $49,725) to the Company were $2,062,775. On July 25, 2006, in order to fulfill its contractual obligations, the Company filed a registration statement with the Securities and Exchange Commission, under the Securities Act of 1933, as amended, to register for resale the shares of common stock sold in this private placement. The Company s registration statement on Form SB-2 covering the securities sold in this private placement was declared effective on August 14, 2006. The Company is obligated to keep the registration statement effective until the earlier of (i) two years after the date of the closing of the private placement, (ii) the date on which the shares may be resold by the purchasers without registration by reason of Rule 144(k) under the Securities Act or any other rule of similar effect, or (iii) such time as all shares purchased by such stockholders have been sold.

(c) Warrants

In conjunction with the sale of the 10% Senior Secured Convertible Notes on June 25, 2008 mentioned above, the Company issued warrants to purchase an aggregate of 316,800 shares of Common Stock at an exercise price of $1.75 per share. The Warrants expire on June 25, 2015 and are not exercisable until the Company implements a reverse stock split, which requires the approval of its stockholders and the effectiveness of an amendment to its Articles of Organization to effect the reverse stock split.

(5) INCOME TAXES

The provision for income taxes in the accompanying consolidated statements of operations consists of the minimum statutory state income tax liability of $912 and $914 for the years ended June 30, 2008 and 2007, respectively.

A reconciliation of the federal statutory rate to the Company s effective tax rate for the two years ended June 30 is as follows:

	2008	2007
Income tax benefit at federal statutory rate	(34.0)%	(34.0)%
Increase (decrease) in tax resulting from- State taxes, net of federal benefit	(6.8)	(5.6)
Change in valuation allowance	43.0	42.3
Nondeductible items	1.1	0.6
Other	(3.2)	(3.3)
Effective tax rate	0.1%	0.0%

The components of deferred tax assets and liabilities at June 30, 2008 and 2007 are approximately as follows:

	2008	2007
Deferred tax assets:		
Net operating loss carry forwards	$ 2,035,000	$ 1,510,000
Tax credit carry forwards	96,000	58,000
Reserves and accruals not yet deducted for tax purposes	151,000	17,000
Total deferred tax assets	2,282,000	1,585,000
Valuation allowance	(2,282,000)	(1,585,000)
Net deferred tax asset	$	$

The Company has provided a valuation allowance to reduce the net deferred tax asset to an amount the Company believes is more likely than not to be realized. The valuation allowance decreased in fiscal 2008 by approximately $697,000.

At June 30, 2008, the Company had federal and state net operating loss carry forwards of approximately $4,400,000 and $4,100,000, respectively, which will, if not used, expire at various dates from 2009 through 2027. In addition, the Company had net operating loss carry forwards from its Hong Kong operations of approximately $1,500,000, which carry forward indefinitely.

(6) PROFIT SHARING PLAN

The Company has a defined contribution 401K profit sharing plan. Employer profit sharing and matching contributions to the plan are discretionary. No employer profit sharing contributions were made to the plan in fiscal years 2008 and 2007. Employer matching contributions to the plan amounted to $17,473 and $42,335 for fiscal years 2008 and 2007, respectively.

(7) CASH SURRENDER VALUE OF LIFE INSURANCE POLICIES

The Company maintains a whole life insurance policy for a senior executive, which policy is recorded at its cash surrender value. As of June 30, 2008 and June 30, 2007, the cash surrender value of these policies is $5,465 and $4,438, respectively.

(8) SALE OF PRODUCT LINE

On January 18, 2008, the Company entered into an Asset Purchase Agreement for the sale of its custom optical thin film product line and completed the sale on the same date. The assets sold included equipment, certain inventory, intellectual property, and a customer list. The purchase price was $250,000, and the Company will also receive a royalty of 25% of revenues exceeding $300,000 annually from the purchased customer list for a three-year period. The Company recognized a gain of $210,549 from the sale of the product line, recorded in the quarter ended March 31, 2008.

Table of Contents

(9) SUBSEQUENT EVENT

Effective as of the open of business on December 11, 2008, the Company effected a reverse stock split of its common stock, par value $0.01 per share. Every twenty-five shares of common stock were reclassified and combined into one share of common stock, and the Company s stock ticker symbol on the OTCBB was changed from POCI.OB to PEYE.OB. No fractional shares were issued as a result of the reverse stock split. Instead, each resulting fractional share of common stock was rounded up to one whole share. The reverse stock split reduced the number of shares of common stock outstanding from 25,458,212 to 1,018,411. The total number of authorized shares of common stock continued to be 50,000,000 and the par value per share of the common stock continued to be $0.01.

All shares and per share data in the accompanying consolidated financial statements reflect the effects of the 1-for-25 reverse stock split that became effective on December 11, 2008. In addition, capital stock has been decreased by $244,398, with a corresponding increase to paid-in capital to reflect the adjusted number of shares of $0.01 par value common stock outstanding as a result of the 1-for-25 reverse stock split.

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

		December 31, 2008		June 30, 2008
ASSETS				
CURRENT ASSETS				
Cash and Cash Equivalents	$	339,124	$	885,988
Accounts Receivable, net		679,347		387,224
Inventories, net		626,660		608,431
Prepaid Expenses		52,417		36,749
Total Current Assets		1,697,548		1,918,392
PROPERTY AND EQUIPMENT				
Machinery and Equipment		2,352,634		2,352,634
Leasehold Improvements		553,596		553,596
Furniture and Fixtures		149,738		149,738
Vehicles		42,343		42,343
		3,098,311		3,098,311
Less: Accumulated Depreciation		(2,954,449)		(2,935,922)
Net Property and Equipment		143,862		162,389
OTHER ASSETS				
Cash surrender value of life insurance policies		5,465		5,465
Patents, net		186,415		195,391
Total Other Assets		191,880		200,856
TOTAL ASSETS	$	2,033,290	$	2,281,637
LIABILITIES AND STOCKHOLDERS EQUITY				
CURRENT LIABILITIES				
Accounts Payable	$	416,356	$	364,409
Customer Advances		12,393		91,105
Accrued Employee Compensation		370,518		293,497
Accrued Professional Services		38,927		94,312
Accrued Warranty Expense		25,000		25,000
Other Accrued Liabilities				912
Total Current Liabilities		863,194		869,235
10% Senior Secured Convertible Notes		334,354		10,304

STOCKHOLDERS EQUITY				
Common Stock, $0.01 par value - Authorized - 50,000,000 shares Issued and Outstanding - 1,018,411 shares at December 31, 2008 and at June 30, 2008		10,184		10,184
Additional Paid-in Capital		38,184,107		38,149,655
Accumulated Deficit		(37,358,549)		(36,757,741)
Total Stockholders Equity		835,742		1,402,098
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	2,033,290	$	2,281,637

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED

DECEMBER 31, 2008 AND 2007

(UNAUDITED)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	2007	2008	2007
Revenues	$ 960,714	$ 579,633	$ 1,620,449	$ 1,681,361
Cost of Goods Sold	470,429	489,607	826,026	1,285,041
Gross Profit	490,285	90,026	794,423	396,320
Research and Development Expenses, net	139,070	241,962	315,680	544,395
Selling, General and Administrative Expenses	387,982	544,512	759,931	1,020,024
Total Operating Expenses	527,052	786,474	1,075,611	1,564,419
Operating Loss	(36,767)	(696,448)	(281,188)	(1,168,099)
Interest Income	1,479	2,988	4,430	7,791
Interest Expense	(138,575)		(324,050)	
Net Loss	$ (173,863)	$ (693,460)	$ (600,808)	$ (1,160,308)
Loss Per Share - Basic and Diluted	$ (0.17)	$ (0.68)	$ (0.59)	$ (1.14)
Weighted Average Common Shares Outstanding - Basic and Diluted	1,018,411	1,018,411	1,018,411	1,018,411

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED

DECEMBER 31, 2008 AND 2007

(UNAUDITED)

	Six Months Ended December 31, 2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (600,808)	$ (1,160,308)
Adjustments to Reconcile Net Loss to Net Cash		
Used In Operating Activities -		
Depreciation and Amortization	32,565	106,686
Stock-based Compensation Expense	34,452	61,738
Non-cash Interest Expense	324,050	
Changes in Operating Assets and Liabilities-		
Accounts Receivable, net	(292,123)	500,966
Inventories	(18,229)	224,853
Prepaid Expenses	(15,668)	(34,469)
Accounts Payable	51,947	(97,674)
Customer Advances	(78,712)	
Other Accrued Expenses	20,724	(84,797)
Net Cash Used In Operating Activities	(541,802)	(483,005)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Property and Equipment		(22,306)
Increase in Other Assets	(5,062)	(28,177)
Net Cash Used In Investing Activities	(5,062)	(50,483)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(546,864)	(533,488)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	885,988	840,179
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 339,124	$ 306,691
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash Paid for-Income Taxes	$ 912	$ 912

The accompanying notes are an integral part of these consolidated financial statements.

PRECISION OPTICS CORPORATION, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Operations

The accompanying consolidated financial statements include the accounts of Precision Optics Corporation, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. All shares and per share data reflect the one-for-twenty-five reverse stock split that became effective on December 11, 2008.

These consolidated financial statements have been prepared by the Company, without audit, and reflect normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results of the second quarter of the Company s fiscal year 2009. These consolidated financial statements do not include all disclosures associated with annual consolidated financial statements and, accordingly, should be read in conjunction with footnotes contained in the Company s consolidated financial statements for the year ended June 30, 2008 together with the Report of Independent Registered Public Accounting Firm filed under cover of the Company s 2008 Annual Report on Form 10-K.

The Company has sustained recurring net losses and negative cash flows from operations for several years. During the six months ended December 31, 2008, the Company incurred a net loss of $600,808 and used cash in operations of $541,802. As of December 31, 2008, cash and cash equivalents were $339,124, accounts receivable were $679,347 and current liabilities were $863,194. These factors raise substantial doubt about the Company s ability to continue as a going concern. The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. During the latter part of fiscal year 2008, the Company implemented plans to reduce costs and to streamline operations in an effort to reduce net losses. This has resulted in an increase in gross profit and simultaneous decreases in operating expenses, thereby reducing losses substantially. The Company believes that the recent introduction of several new products, along with new and on-going customer relationships, will generate additional revenues, which are required in order for us to achieve profitability. If these additional revenues are not achieved on a timely basis, the Company will be required and is prepared to implement further cost reduction measures, as necessary.

The Company incurred quarter to quarter operating losses during its recent efforts to develop current products including endoscopes, image couplers, beamsplitters, thin film coatings, night vision and micro-optic lenses, prisms and assemblies for various applications and utilizing a number of proprietary and patent-pending technologies including Lenslock TM endoscope and micro-precision TM lens technologies. Management expects that such operating losses will continue through fiscal year 2009, and until sales increase to breakeven and profitable levels. Management also believes that the opportunities represented by these products have the potential to generate sales increases to achieve breakeven and profitable results. The Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved. There can be no assurance that the Company s operating plans will be successful, and if so required, that we will be successful in obtaining the capital necessary to continue ongoing operations.

In June 2008, the Company issued $600,000 of Senior Secured Convertible Notes and warrants to purchase an aggregate of 316,800 shares of common stock at an exercise price of $1.75 per share, raising cash proceeds of $600,000. In February 2007, the Company completed a private placement, pursuant to which it sold an aggregate of 400,000 shares of common stock and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of $8.00 per share. Net cash proceeds to the Company (after offering costs of $123,784) were $2,376,216.

During the past year, the introduction of several new products, along with new and on-going customer relationships, has resulted in significant revenue growth. The Company believes that with continued promotion, these opportunities have the potential to continue the general trend of increasing revenues, which, along with enhanced operations are required in order for the Company to achieve profitability.

Use of Estimates

The preparation of these consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making

Table of Contents

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.

Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the three and six months ended December 31, 2008 and 2007, the effect of stock options and warrants was anti-dilutive; therefore, they were not included in the computation of diluted loss per share. The number of shares issuable upon the exercise of outstanding stock options and warrants that were excluded from the computation as their effect would be anti-dilutive were approximately 991,800 and 502,500 for the three and six months ended December 31, 2008 and 2007, respectively.

Revenue Recognition

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB No. 104), which requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed or determinable; and (4) collectibility is reasonably assured. The Company s shipping terms are customarily FOB shipping point. The Company s revenue recognition practices comply with the guidance in the bulletin.

Inventories

The Company provides for estimated obsolescence on unmarketable inventory based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Inventory, once written down, is not subsequently written back up, as these adjustments are considered permanent adjustments to the carrying value of the inventory.

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

The Company accounts for impairment of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset 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 undiscounted future net cash flows expected to be generated by the 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less estimated costs to sell.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In assessing the likelihood of utilization of existing deferred tax assets, management has considered historical results of operations and the current operating environment. Based on this evaluation, a full valuation reserve has been provided for the deferred tax assets.

Stock-Based Compensation

The Company accounts for stock based compensation in accordance with SFAS No. 123(R), *Accounting for Stock-Based Compensation* (SFAS No. 123(R)), which requires the measurement and recognition of all compensation costs for all stock-based awards made to employees and the Board of Directors based upon fair value over the requisite service period for awards expected to vest.

SFAS 123(R) requires us to estimate the fair value of stock-based awards on the date of grant using an option-pricing model. The Company adopted SFAS 123(R) using the modified prospective transition method which required the application of the accounting standard starting July 1, 2006, the first day of the Company s fiscal year 2007. Prior period information has not been restated to reflect the fair value method of expensing stock-based awards.

Table of Contents

Recent Accounting Pronouncements

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and provides entities with a framework for selecting the principles used in preparation of financial statements that are presented in conformity with GAAP. The current GAAP hierarchy has been criticized because it is directed to the auditor rather than the entity, it is complex, and it ranks FASB Statements of Financial Accounting Concepts, which are subject to the same level of due process as FASB Statements of Financial Accounting Standards, below industry practices that are widely recognized as generally accepted but that are not subject to due process. The FASB believes the GAAP hierarchy should be directed to entities because it is the entity (not its auditors) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. The adoption of FASB 162 is not expected to have any impact on the Company s financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 requires additional disclosures related to the use of derivative instruments, the accounting for derivatives and how derivatives impact financial statements. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 161 is not expected to have a material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity s fiscal year that begins after December 15, 2008; July 1, 2009 for the Company. The impact of this Statement on the Company s financial position, results of operations and cash flows will be dependent on the terms, conditions and details of such acquisitions.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which provides a single definition of fair value, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement defined as the price that would be received to sell an asset or liability in an orderly transaction between market participants at the measurement date. Thus, SFAS No. 157 adheres to a definition of fair value based upon exit price as opposed to entry price, i.e. the price paid to acquire an asset or liability. This pronouncement is effective for fiscal years beginning after November 15, 2007; July 1, 2008 for the Company. The Company is in the process of evaluating the impact of this authoritative guidance on its consolidated financial statements.

2. INVENTORIES

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

	December 31, 2008	**June 30, 2008**

Raw Materials	$	432,575	$	347,298
Work-In-Progress		143,444		177,464
Finished Goods		50,641		83,669
Total Inventories	$	626,660	$	608,431

3. 10% SENIOR SECURED CONVERTIBLE NOTES

The 10% Senior Secured Convertible Notes consist of the following:

		December 31, 2008		June 30, 2008
10 % Senior Secured Convertible Notes issued on June 25, 2008, convertible into common stock at $1.25 per share, bearing interest at 10% per annum. Outstanding principal and accrued interest are due at maturity, June 25, 2010.	$	600,000	$	600,000
Accrued interest 10% coupon		30,833		833
Unamortized discount		(296,479)		(590,529)
	$	334,354	$	10,304

Table of Contents

In June 2008, the Company issued Senior Secured Convertible Notes and Warrants, raising cash proceeds of $600,000. The proceeds were allocated between the Notes and Warrants based on relative fair values. The value of the Warrants was recorded as a discount to the Notes, with a corresponding increase to additional paid-in capital. The fair value of the Warrants was determined using the Black-Scholes method, with the following assumptions:

Expected life	7 years
Risk-free rate	4.84%
Expected Dividends	0.00%
Volatility factor	154%

In accordance with EITF 00-27, *Application of EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,* the proceeds from the issuance of the 10% Senior Secured Convertible Notes were first allocated between the Notes and the Warrants. The value of the conversion feature was then calculated, which resulted in an effective conversion ratio that was less than the market price of the Company s common stock. The intrinsic value of this beneficial conversion feature was recorded as a further discount to the Notes, equal to the difference between the effective conversion ratio and the market price of the Company s common stock, with a corresponding increase to additional paid-in capital.

The following summarizes the discount on 10% Senior Secured Convertible Notes:

		December 31, 2008		**June 30, 2008**
Discount beginning balance	$	590,529	$	
Proceeds allocated to warrants				399,000
Beneficial conversion feature intrinsic value				201,000
Less: amortization of discount		(294,050)		(9,471)
Discount ending balance	$	296,479	$	590,529

4. STOCK-BASED COMPENSATION

Stock-based compensation costs recognized during the three and six month periods ended December 31, 2008 amounted to $20,392 and $34,452, respectively, and for the three and six month periods ended December 31, 2007 amounted to $34,264 and $61,738, respectively, and was included in the accompanying consolidated statements of operations. No compensation has been capitalized because such amounts would have been immaterial. There was no net income tax benefit recognized related to such compensation for the three and six month periods ended December 31, 2008 and 2007, as the Company is currently in a loss position. The total number of options granted during the three and six month periods ended December 31, 2008 were 1,200 and 1,200, respectively.

As of December 31, 2008, the unrecognized compensation costs related to options vesting will be primarily recognized over a period of approximately 3 years:

OPTIONS	2009	2010	2011	Total
Compensation Expense	$ 37,896	$ 12,703	$ 12,703	$ 63,302

	Six Months Ended	
	December 31, 2008	December 31, 2007
Assumptions:		
Option life	5.3 years	5.3 years
Risk-free interest rate	2.06%	4.84%
Stock volatility	179%	147%
Dividend yield	0	0
Weighted average fair value of grants	$ 1.25	$ 7.75

The following tables summarize stock option activity during the first six months of fiscal year 2009:

		Options Outstanding	
	Number of Shares	Weighted Average Exercise Price	Weighted Average Contractual Life
Outstanding at June 30, 2008	97,232	$ 15.75	7.56 years
Grants	1,200	1.25	
Exercises			
Cancellations	(5,254)	6.50	
Outstanding at December 31, 2008	93,178	$ 16.17	$ 7.06 years

Information related to the stock options outstanding as of December 31, 2008 is as follows:

Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Exercisable Number of Shares	Exercisable Weighted-Average Exercise Price
$1.25	1,200	9.91	$ 1.25	1,200	$ 1.25
$6.25	1,600	7.92	6.25	1,600	6.25
$7.75	1,200	8.91	7.75	1,200	7.75
$11.50	800	6.92	11.50	800	11.50
$13.75	51,018	7.36	13.75	39,770	13.75
$20.75	37,360	6.46	20.75	37,360	20.75
$1.25-$20.75	93,178	7.06	$ 16.17	81,930	$ 16.50

The aggregate intrinsic value of the Company s in-the-money outstanding and exercisable options as of June 30, 2008 was $0 and $0, respectively, and as of December 31, 2008 was $0 and $0, respectively.

5. STOCKHOLDERS EQUITY

Registration Statement

On December 18, 2008, the Company filed a registration statement on Form S-1 to register the disposition by selling stockholders of 1,074,621 shares of common stock, which included 480,000 shares underlying convertible promissory notes, 96,000 shares underlying potential interest due on the notes and 498,621 shares underlying warrants. The Company will not receive any proceeds from the sale or other disposition of common stock by the selling stockholders. The Company may receive proceeds from the exercise of warrants. As of February 13, 2009, the registration statement had not yet been declared effective by the U.S. Securities and Exchange Commission.

Reverse Stock Split

Effective as of the open of business on December 11, 2008, the Company effected a reverse stock split of its common stock, par value $0.01 per share. Every twenty-five shares of common stock were reclassified and combined into one share of common stock, and the Company s stock ticker symbol on the OTCBB was changed from POCI.OB to PEYE.OB. No fractional shares were issued as a result of the reverse stock split. Instead, each resulting fractional share of common stock was rounded up to one whole share. The reverse stock split reduced the number of shares of common stock outstanding from 25,458,212 to 1,018,411. The total number of authorized shares of common stock continued to be 50,000,000 and the par value per share of the common stock continued to be $0.01.

All shares and per share data in the accompanying consolidated financial statements reflect the effects of the 1-for-25 reverse stock split that became effective on December 11, 2008. In addition, capital stock has been decreased by $244,398, with a corresponding increase to paid-in capital to reflect the adjusted number of shares of $0.01 par value common stock outstanding as a result of the 1-for-25 reverse stock split.

Table of Contents

Warrants

In conjunction with the sale of the 10% Senior Secured Convertible Notes on June 25, 2008 mentioned above, the Company issued warrants to purchase an aggregate of 316,800 shares of common stock at an exercise price of $1.75 per share. The warrants became exercisable on December 11, 2008 and expire on June 25, 2015.

On February 1, 2007, the Company sold an aggregate of 400,000 shares of common stock, par value $0.01 per share, at a price of $6.25 per share and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of $8.00 per share, which were immediately exercisable, raising gross proceeds of $2,500,000. In conjunction with the issuance by the Company of senior convertible notes and warrants on June 25, 2008, certain anti-dilution provisions of the existing warrants were triggered. As a result, the number of existing warrants was increased from 400,000 to 581,821 and the related exercise price was decreased from $8.00 per share to $5.50 per share.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

The following is a discussion of our financial condition and results of operations. To the extent that our analysis contains statements that are not of a historical nature, these statements are forward-looking statements, which involve risks and uncertainties. The following should be read in conjunction with our financial statements and the related notes included elsewhere in this prospectus.

Cautionary Statement Concerning Forward-Looking Statements

This prospectus contains forward-looking statements that involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including the risks described in this prospectus and other reports we file with the Securities and Exchange Commission. Although we believe the expectations reflected in the forward-looking statements are reasonable, they relate only to events as of the date on which the statements are made. We do not intend to update any of the forward-looking statements after the date of this document to conform these statements to actual results or to changes in our expectations, except as required by law.

The following discussion and analysis should be read in conjunction with the Financial Statements and Notes thereto, and other financial information included elsewhere in this prospectus.

Overview

We have been a developer and manufacturer of advanced optical instruments since 1982. We design and produce high-quality micro-optics, medical instruments and other advanced optical systems. Our medical instrumentation line includes laparoscopes, arthroscopes and endocouplers and a world-class product line of 3-D endoscopes for use in minimally invasive surgical procedures.

We are currently developing specialty instruments incorporating our Lenslock TM technology (patent pending) that ensures lower cost, easier reparability and enhanced durability as compared to other design approaches used in the industry. We are also aggressively pursuing ultra-small instruments, some with lenses less than one millimeter in diameter, utilizing micro-precision TM lens technology (patent pending).

We are certified to the ISO 9001 and ISO 13485 Quality Standards and comply with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE marking of our medical products. Our internet website is www.poci.com. Information contained on our website does not constitute part of this prospectus.

The areas in which we do business are highly competitive and include both foreign and domestic competitors. Many of our competitors are larger and have substantially greater resources than we do. Furthermore, other domestic or foreign companies, some with greater financial resources than we have, may seek to produce products or services that compete with ours. We routinely outsource specialized production efforts as required, both domestic and offshore, to obtain the most cost effective production. Over the years, we have achieved extensive experience with other optical specialists worldwide.

Since the 1990s, we have maintained a Hong Kong subsidiary to support business and quality control activities as required throughout Asia. We believe that the cost savings from such production is essential to our ability to compete on a price basis in the medical products area particularly and to our profitability in general.

Table of Contents

We believe that competition for sales of our medical products and services, which have been principally sold to original equipment manufacturer, or OEM, customers, is based on performance and other technical features, as well as other factors, such as scheduling and reliability, in addition to competitive price.

We believe that our future success depends to a large degree on our ability to continue to conceive and to develop new optical products and services to enhance the performance characteristics and methods of manufacture of existing products. Accordingly, we expect to continue to seek to obtain product-related design and development contracts with customers and to invest our own funds on research and development, to the extent funds are available.

Critical Accounting Policies and Estimates

General

Management s discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, referred to as U.S. GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various other assumptions 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.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenue in accordance with the Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements* (SAB No. 104). SAB No. 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed or determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management s judgments regarding the fixed nature of the price to the buyer charged for products delivered or services rendered and collectability of the sales price. We assess credit worthiness of customers based upon prior history with the customer and assessment of financial condition. Our shipping terms are customarily Free On Board, or FOB, shipping point.

Inventories

We provide for estimated obsolescence on unmarketable inventory based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Inventory, once written down, is not subsequently written back up, as these adjustments are considered permanent adjustments to the carrying value of the inventory.

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

We account for impairment of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset 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 undiscounted future net cash flows expected to be generated by the 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less estimated costs to sell.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the likelihood of utilization of existing deferred tax assets, management has considered historical results of operations and the current operating environment.

Stock-Based Compensation

On July 1, 2006, we adopted SFAS No. 123(R), *Accounting for Stock-Based Compensation* (SFAS No. 123(R)), which requires the measurement and recognition of all compensation costs for all stock-based awards made to employees and the Board of Directors based upon fair value over the requisite service period for awards expected to vest.

SFAS 123(R) requires us to estimate the fair value of share-based awards on the date of grant using an option pricing model. We adopted SFAS 123(R) using the modified prospective transition method which required the application of the accounting standard starting July 1, 2006, the first day of our fiscal year 2007. Prior period information has not been restated to reflect the fair value method of expensing share-based awards.

Recent Accounting Pronouncements

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and provides entities with a framework for selecting the principles used in preparation of financial statements that are presented in conformity with GAAP. The current GAAP hierarchy has been criticized because it is directed to the auditor rather than the entity, it is complex, and it ranks FASB Statements of Financial Accounting Concepts, which are subject to the same level of due process as FASB Statements of Financial Accounting Standards, below industry practices that are widely recognized as generally accepted but that are not subject to due process. The FASB believes the GAAP hierarchy should be directed to entities because it is the entity (not its auditors) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. We do not expect the adoption of FASB 162 to have any impact on our financial position.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS 160). SFAS 160 introduces significant changes in the accounting and reporting for business acquisitions and noncontrolling interest (NCI) in a subsidiary. SFAS 160 also changes the accounting and reporting for the deconsolidation of a subsidiary. Companies are required to adopt the new standard for fiscal years beginning after January 1, 2009. We expect the adoption of this standard will have no impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity s fiscal year that begins after December 15, 2008, or July 1, 2009 for our Company. The impact of this Statement on our financial position, results of operations and cash flows will be dependent on the terms, conditions and details of such acquisitions.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which allows us to choose to measure selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, or July 1, 2008 for our Company. We are in the process of evaluating the impact of this authoritative guidance on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which provides a single definition of fair value, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement defined as the price that would be received to sell an asset or liability in an orderly transaction between market participants at the measurement date. Thus, SFAS No. 157 adheres to a definition of fair value based upon exit price as opposed to entry price, i.e. the price paid to acquire an asset or liability. This pronouncement is effective for fiscal years beginning after November 15, 2007, or July 1, 2008 for our Company. We are in the process of evaluating the impact of this authoritative guidance on our consolidated financial statements.

Table of Contents

Results of Operations for the Fiscal Year Ended June 30, 2008 Compared to the Fiscal Year Ended June 30, 2007

During the latter part of fiscal year 2008, we implemented plans to reduce costs, including workforce reductions, and to streamline operations in an effort to reduce net losses. This has resulted in an increase in gross profit and simultaneous decreases in operating expenses, thereby reducing losses, particularly in the third and fourth quarters of fiscal year 2008. Excluding the effect of the gain on sale of product line in January 2008, operating loss for the quarters ended March 31, 2008 and June 30, 2008 was the lowest of any quarter in the last nine years. We anticipate continuing measures taken to contain costs, and to continue our review of other expense areas to determine where additional reductions in discretionary spending can be achieved.

Total revenues for fiscal year 2008 were $2,902,219, an increase of $424,750, or 17.1%, from fiscal year 2007 revenues of $2,477,469. The revenues for fiscal 2008 represents the highest yearly sales level in seven years and was due principally to shipments to a significant new customer of an advanced surgical visualization system, along with the introduction of a number of other new products. The design of the advanced surgical visualization system relied heavily on our experience with medical optics technologies, specifically in the area of advanced optical endoscopic instrumentation.

Revenues from our largest customers, as a percentage of total revenues, were as follows:

	2008	**2007**
Customer A	25%	27%
Customer B	20	22
Customer C	11	10
All Others	44	41
	100%	100%

No other customer accounted for more than 10% of our revenues in fiscal years 2008 and 2007.

Gross profit for fiscal year 2008 reflected a favorable change of $316,729, compared to fiscal year 2007. Gross profit as a percentage of revenues increased from 19.2% in fiscal year 2007 to 27.3% in fiscal year 2008. The favorable change in gross profit was due primarily to increased sales volume, increased manufacturing efficiencies and elimination of 2007 start-up costs related to initial production of the advanced surgical visualization system.

Research and development expenses, net were $757,852 for fiscal year 2008, compared to $1,312,240 for fiscal year 2007. The decrease was due primarily to the recent implementation of certain cost containment plans including workforce reductions, deferring certain development initiatives, increased reimbursements from customers for product development activities and focusing on a limited number of products and technologies expected to provide near term revenues. Research and development expenses were net of reimbursement of related costs of $224,107 and $101,309 during fiscal years 2008 and 2007, respectively.

Selling, general and administrative expenses decreased by $230,866, or 11.0%, during fiscal year 2008 compared to the previous year. The decrease was primarily attributable to the recent implementation of certain cost containment plans including workforce reductions, as mentioned above.

Gain on sale of product line of $210,549 consists of the gain on the sale of our optical thin film product line recognized in the quarter ended March 31, 2008. The purchase price was $250,000, and we will receive a royalty of 25% of revenues exceeding $300,000 annually from the purchased customer list for a three-year period.

Interest income (expense), net decreased by $46,059 during fiscal year 2008 compared to the previous year. The decrease was due to a lower base of cash and cash equivalents, partially offset by higher interest rates, and interest expense recorded on the 10% senior convertible notes issued on June 25, 2008.

The income tax provisions in fiscal years 2008 and 2007 represent the minimum statutory state income tax liability.

Results of Operations for the Quarter Ended December 31, 2008 Compared to the Quarter Ended December 31, 2007

During the latter part of fiscal year 2008, we implemented plans to reduce costs, including workforce reductions, to focus sales efforts on higher margin products, and to streamline operations in an effort to reduce net losses. These efforts, combined with recent increases in sales, resulted in an increase in gross profit and a simultaneous decrease in operating expense beginning in the third quarter of fiscal year 2008 and continuing with the first half of fiscal year 2009. Excluding the effect of the gain on sale of product line in January 2008, operating loss for the quarter ended December 31, 2008 was the lowest of any quarter in the last twelve years. We

Table of Contents

anticipate continuing the measures taken to contain costs, and to continue our review of other expense areas to determine where additional reductions in spending can be achieved.

Our total revenues for the quarter ended December 31, 2008, the second quarter of our fiscal year 2009, were $960,714, an increase of $381,081, or 65.7%, from the same period last year. Our total revenues for the six months ended December 31, 2008 were $1,620,449, a decrease of $60,912, or 3.6%, from the same period last year. The increase in revenues for the current quarter was due principally to increases in sales of new optical components and fiber scopes utilizing our micro-precision TM lens and prism technology beginning in the quarter ended September 30, 2008 and resumption of shipments of an advanced surgical visualization system. The decrease in revenues for the six months ended December 31, 2008 was due principally to shipments to a significant new customer of an advanced surgical visualization system last year, partially offset by sales of the new optical components and fiber scopes. Although there were no shipments of the advanced surgical visualization system in the quarter ended September 30, 2008, we resumed shipments of this product in the quarter ended December 31, 2008.

Revenues from our largest customers, as a percentage of total revenues, for the six months ended December 31, 2008 and 2007, were as follows:

	2008	2007
Customer A	30%	9%
Customer B	18	16
Customer C	11	7
Customer D	7	38
All Others	34	30
	100%	100%

No other customer accounted for more than 10% of the Company s revenues during those periods.

Gross profit for the quarter ended December 31, 2008 was $490,285, which reflects an increase of $400,259, compared to the quarter ended December 31, 2007. Gross profit for the quarter ended December 31, 2008 as a percentage of revenues increased from 15.5% for the quarter ended December 31, 2007 to 51.0% in the current quarter. Gross profit for the six months ended December 31, 2008 was $794,423, which reflects an increase of $398,103, compared to the six months ended December 31, 2007. Gross profit for the six months ended December 31, 2008 as a percentage of revenues increased from 23.6% for the six months ended December 31, 2007 to 49.0% in the current year. The favorable change in our gross profit percentage was due primarily to increased manufacturing efficiencies, favorable change in product mix and certain cost containment plans implemented in fiscal year 2008 as discussed above.

Research and development expenses were $139,070 for the quarter ended December 31, 2008, compared to $241,962 for the same period last year, a reduction of $102,892, or 42.5%. Research and development expenses were $315,680 for the six months ended December 31, 2008, compared to $544,395 for the same period last year, a reduction of $228,715, or 42.0%. The decrease was due primarily to the implementation of certain cost containment plans in fiscal year 2008 including workforce reductions, deferment of certain development initiatives, increased reimbursements from customers for product development activities and increased focus on a limited number of products and technologies expected to provide near term revenues. Quarterly research and development expenses depend on our assessment of new product opportunities and available resources. Research and development expenses were net of reimbursement of related costs of $168,856 and $18,693 during the quarters ended December 31, 2008 and 2007, respectively.

Selling, general and administrative expenses were $387,982, a decrease of $156,530, or 28.7%, for the quarter ended December 31, 2008 compared to the same period last year. Selling, general and administrative expenses were $759,931, a decrease of $260,093, or 25.5%, for the six months ended December 31, 2008 compared to the same period last year. The decrease was due primarily to the implementation of certain cost containment plans in fiscal year 2008 including workforce reductions, as mentioned above. This was partially offset by higher nonrecurring legal, accounting and transfer agent fees amounting to approximately $57,000 recorded in the quarter ended December 31, 2008, related to the preparation and filing of a registration statement and implementation of a 1-for-25 reverse stock split in December 2008, as contractually required by the June 2008 financing transaction. Without these unusual nonrecurring expenses, our operating profit would have been positive for the quarter ended December 31, 2008.

Interest income decreased by $1,509 and $3,361, respectively, for the third and six months ended December 31, 2008, compared to the same periods last year. The decrease was due to a lower base of cash and cash equivalents.

Interest expense increased by $138,575 and $324,050, respectively, for the third and six months ended December 31, 2008, compared to the same periods last year. The increase was due to the accrual of non-cash interest expense (including the amortization of debt discount) on the 10% Senior Secured Convertible Notes issued on June 25, 2008.

Table of Contents

No income tax provision was recorded in the second quarter of fiscal year 2009 or 2008 because of the losses generated in those periods.

Liquidity and Capital Resources

Liquidity and Capital Resources

We compete in a highly technical, very competitive, and in most cases, price driven segment of the medical instrument marketplace where products can take years to develop and introduce to distributors and end users. Furthermore, research and development, manufacturing, marketing and distribution activities are strictly regulated by FDA, ISO and other regulatory bodies that, while intended to enhance the ultimate quality and functionality of products produced, can contribute to the significant cost and time needed to maintain existing products and develop and introduce product enhancements and new product innovations.

We have traditionally funded working capital needs through product sales, management of working capital components of our business, and by cash received from public and private offerings of our common stock, warrants to purchase shares of our common stock and convertible notes. We have incurred quarter to quarter operating losses during our efforts to develop current products including endoscopes, image couplers, beamsplitters, thin film coatings, night vision and micro-optic lenses, prisms and assemblies for various applications and utilizing a number of proprietary and patent-pending technologies including Lenslock TM endoscope and micro-precision TM lens technologies. Our management expects that such operating losses will continue through fiscal year 2009 and until sales increase to breakeven and profitable levels. Our management also believes that the opportunities represented by these products have the potential to generate sales increases to achieve breakeven and profitable results. Excluding the effect of the gain on sale of product line in January 2008, operating loss for the quarter ended December 31, 2008 was the lowest of any quarter in the last twelve years.

Our current financial condition may raise doubt among potential equity investors, customers and suppliers regarding our ability to continue as a going concern, as referenced by the Report of Independent Registered Public Accounting Firm on our financial statements for the year ended June 30, 2008, included in our annual report on Form 10-K. We may not be able to obtain working capital funds if necessary in the time frame needed and at satisfactory terms to correct the going concern issue.

As of December 31, 2008, cash and cash equivalents were $339,124, accounts receivable were $679,347 and current liabilities were $863,194. We believe that the introduction of several new products during the last four fiscal years, along with new and on-going customer relationships, will continue to generate additional revenues, which are required in order for us to achieve profitability. If these additional revenues are not achieved on a timely basis, we will be required and are prepared to implement further cost reduction measures, as necessary.

During the six months ended December 31, 2008, we used cash in operations of $541,802. While this represents an increase in cash used in operations of $58,797 over the same period a year earlier, this year s cash usage was accompanied by an increase in receivables of $292,123, while cash usage a year ago was accompanied by a decrease in receivables of $500,966.

Contractual cash commitments for the fiscal years subsequent to December 31, 2008 are summarized as follows:

	2009	2010	Thereafter	Total
Operating Leases	$ 16,900	$ 5,600	$ 1,900	$ 24,400
Principal and Interest (1)		720,000		720,000
Totals	$ 16,900	$ 725,600	$ 1,900	$ 744,400

(1) This amount may be reduced to the extent the 10% Senior Secured Convertible Notes and Interest are converted into common stock.

We have contractual cash commitments related to open purchase orders at December 31, 2008 of approximately $165,000.

We generally provide a standard one-year warranty on materials and workmanship to our customers. We provide for estimated warranty costs at the time product revenue is recognized. Warranty costs are included as a component of cost of goods sold in the accompanying consolidated statements of operations. For the three and six month periods ended December 31, 2008 and 2007, warranty costs were not significant.

Table of Contents

Trends and Uncertainties That May Affect Future Results

Our fiscal year 2008 revenues were the highest in seven years. This was due in large part to shipments of the advanced surgical visualization system discussed in results of operations above, the design of which relies heavily on our world-class medical optics technologies, specifically in the area of advanced optical endoscopic instrumentation. While we had no orders for shipments of this product from the third quarter of fiscal year 2008 through the first quarter of fiscal year 2009, we resumed shipments in the second quarter of fiscal year 2009.

We expect our recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the introductory stage of many of our products and the unpredictable timing of orders from customers and the size of those orders in relation to total revenues. Contingent on available funding, we intend to continue to develop and commercialize new products and technical innovations, in particular:

- a new generation of endoscopes that incorporate Lenslock TM technology (patent pending);
- new components and instruments utilizing our new micro-precision TM lens technology (patent pending) for optical components and endoscopes under 1 mm;
- new custom medical products; and
- new night vision lenses.

However, if we do not have sufficient capital to develop and commercialize these products, our future revenues may decline because we cannot offer the innovative products the market is seeking. Over the past few years, we have implemented significant changes in new product and technology development by shifting the emphasis of research and development efforts from developing underlying technologies to commercialization of the applications of these new technologies. These have already been realized to some degree in a number of areas. Over the past two to three years our efforts have produced revenues from our new micro-precision TM lens products and new Lenslock TM endoscopes. Recent initiatives in the area of micro-precision TM lenses address specific customer opportunities in different medical specialty applications. In endoscope technologies, we continue new product offerings in our Lenslock TM product line. Since December 2005, we have shipped over 400 ENT endoscopes with diameter of 2.7 mm that incorporate Lenslock TM technology. We recently completed prototypes of our 4 mm Lenslock TM sinuscope, and 5 mm Lenslock TM laproscope, and are actively pursuing development of our new 4 mm Lenslock TM wide field arthroscope. We believe that our Lenslock TM technology has advantages over competitive products due to ease of manufacture and repair, superior image quality, significant cost effectiveness and quality of repair. We anticipate that further incorporating this technology into our endoscope product line will lead to increased sales.

Going forward, we intend to focus our development efforts on products we believe offer the best prospects to increase our near-term revenues. An example beyond the new instruments mentioned above includes the lenses we developed for a new color Night Vision system. During the quarter ended December 31, 2008, we shipped first article pre-production lens systems. These are for use in the new color Night Vision system, and utilize an improved design that offers lower cost and lighter weight.

For the quarter ended December 31, 2008, our cash and cash equivalents decreased by $339,124 compared to a decrease of $251,296 for the previous quarter ended September 30, 2008 as a result of negative cash flows from operating activities. However, we expect that our cash flow for the quarter ending March 31, 2009 will improve as a result of the relatively high level of sales and accounts receivable generated in the second quarter. If our cash reserves continue to decrease, we will be required to seek additional funding. The sale of additional equity or convertible debt securities would result in additional dilution to our stockholders, and debt financing, if available, may involve restrictive covenants that could restrict our operations or finances. Financing may not be available in amounts or on terms acceptable to us, if at all. If we cannot raise funds on acceptable terms or achieve positive cash flow, we may not be able to continue to conduct operations, develop new products, grow market share, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which would negatively impact our business, operating results and financial condition.

Our capital equipment expenditures during the quarter ended December 31, 2008 were $0 compared to $22,306 for the same period in 2007. Future capital equipment expenditures will depend on future sales and success of on-going research and development efforts.

Section 404 of the Sarbanes-Oxley Act of 2002, requiring companies to report on the effectiveness of internal controls over financial reporting, first applied to our annual report on Form 10-K for the fiscal year ended June 30, 2008. We expect our operating expense may increase as a result of the costs associated with the implementation of and maintaining compliance with Section 404.

Off-Balance Sheet Transactions

We currently have no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Table of Contents

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no disagreements with our independent public accountant in regards to accounting and financial disclosure.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS

The following table sets forth the name, age, positions, and offices or employments for the past five years as of April 3, 2009, of our directors and executive officers:

NAME	AGE	POSITION
Richard E. Forkey	68	President, Chief Executive Officer, Treasurer and Chairman
Joseph N. Forkey	41	Executive Vice President, Chief Scientific Officer and Director
Jack P. Dreimiller	60	Senior Vice President, Finance, Chief Financial Officer and Clerk*
Michael T. Pieniazek	50	Vice President, Chief Financial Officer and Clerk*
Joel R. Pitlor	70	Director
Donald A. Major	47	Director
Richard Miles	65	Director

* Effective August 15, 2008, Mr. Pieniazek resigned as our Vice President, Chief Financial Officer and Clerk, and effective August 15, 2008, Jack P. Dreimiller was appointed to serve as our Senior Vice President, Finance, Chief Financial Officer and Clerk.

BIOGRAPHIES OF EXECUTIVE OFFICERS AND DIRECTORS

Richard E. Forkey has been our President, Chief Executive Officer, Treasurer, and the Chairman of our board of directors since he founded our Company in 1982. He was the Clerk of the Company from May 1983 to June 1990.

Dr. Joseph N. Forkey, son of Richard E. Forkey, has been our Executive Vice President and Chief Scientific Officer since April 2006 and served as our Chief Scientist from September 2003 to April 2006. In April 2006, Dr. Forkey was appointed to serve as a director on our board. Since joining our Company, he has been involved in our general technical and management activities, as well as investigations of opportunities that leverage our newly developed technologies. Dr. Forkey holds B.A. degrees in Mathematics and Physics from Cornell University, and a Ph.D. in Mechanical and Aerospace Engineering from Princeton University. Prior to joining us, Dr. Forkey spent seven years at the University of Pennsylvania Medical School as a postdoctoral fellow and research staff member.

Jack P. Dreimiller has been our Senior Vice President, Finance, Chief Financial Officer and Clerk since August 15, 2008 and also served as our Senior Vice President, Finance and Chief Financial Officer from April 1992 until June 2005 and our Clerk from January 1998 until June 2005. Since June 2005, he has served as an independent consultant serving various roles as financial/accounting executive, including interim Chief Financial Officer, for a number of companies. From June 2005 to December 2005, he was an independent consultant to our Company.

Michael T. Pieniazek served as our Vice President, Chief Financial Officer and Clerk from September 2006 until his resignation effective as of August 15, 2008. From January 2006 to November 2006, Mr. Pieniazek was President and Chief Financial Officer of MIP Solutions, Inc. From September 2001 to December 2005, Mr. Pieniazek was President and Chief Financial Officer of Uromedical Diagnostic, Inc.

Joel R. Pitlor has served as a director on our board since June 1990. Since 1979, Mr. Pitlor has been President of J.R. Pitlor, a management consulting firm that provides strategic business planning, which Mr. Pitlor founded. Mr. Pitlor has provided business planning consultation to our Company since 1983.

Donald A. Major has served as director on our board since August 2005. Since 2002, Mr. Major has served as Vice President and Treasurer of Anderson Entertainment, LLC (formerly Digital Excellence LLC). From October 2006 to May 2007, Mr. Major served as Vice President of Corporate Development of Advanced Duplication Services LLC. Since October 2007, Mr. Major s primary occupation has been as an independent consultant to a private equity firm where he is engaged in identifying, evaluating and implementing corporate investment opportunities.

Richard Miles has served as a director on our board since November 2005. Since 1972, Professor Miles has been a member of the faculty at Princeton University and serves as the Director of the Applied Physics Group in Princeton University s Mechanical and Aerospace Engineering Department.

EXECUTIVE COMPENSATION

Summary Compensation

The following table sets forth all compensation for the last two completed fiscal years ended June 30, 2008 and 2007 awarded to, earned by, or paid to our Principal Executive Officer, Vice President and Chief Scientific Officer and one of our employees, referred to herein as the Named Executive Officers. No other executive officer or employee earned over $100,000 in the last completed fiscal year.

Summary Compensation Table for the Fiscal Years Ended June 30, 2008 and 2007

Name and principal position (a)	Year June 30, (b)	Salary ($) (c)	Bonus ($) (d)	Stock awards ($) (e)	Option awards ($) (f)	Non-equity incentive plan compensation ($) (g)	Non-qualified deferred compensation earnings ($) (h)	All other compensation ($) (i)	Total ($) (j)
Richard E. Forkey									
President, Principal									
Executive	2008	$ 195,000	0	0	0	0	0	$ 23,984(1)(2)	$ 218,984
Officer and Treasurer	2007	$ 195,000(4)	0	0	0	0	0	$ 27,224(1)(2)	$ 222.224
Joseph N. Forkey									
Executive Vice President									
and	2008	$ 120,000	0	0	0	0	0	$ 1,200(3)	$ 121,200
Chief Scientific Officer	2007	$ 120,000(4)	0	0	0	0	0	$ 2,400(3)	$ 122,400
Richard G. Cyr	2008	$ 117,027	0	0	0	0	0	$ 1,236(3)	$ 118,263
Optical Shop Manager	2007	$ 117,430	0	0	0	0	0	$ 2,348(3)	$ 119,778

(1) Includes car expense of $2,100 for 2008 and $2,100 for 2007.

(2) Includes premiums for a life insurance policy and a disability insurance policy of $18,579 for 2008 and $20,394 for 2007.

(3) Represents our Company s matching contribution to the Profit Sharing & 401(k) Plan.

(4) Based on new compensation arrangements approved by the board of directors on April 15, 2008 for our Principal Executive Officer and for our Chief Scientific Officer, $66,883 and $923, respectively, of these amounts were deferred, and will be paid in the form of restricted stock that will be subject to future performance based vesting.

Narrative to Summary Compensation Table

Employment Contracts and Termination of Employment Arrangements

We have no employment contracts in place with any Named Executive Officer. We have no compensatory plan or arrangement with respect to any Named Executive Officer where such plan or arrangement will result in payments to such Named Executive Officer upon or following his resignation, or other termination of employment with our Company and its subsidiaries, or as a result of a change-in-control of our Company or a change in the Named Executive Officers responsibilities following a change-in-control.

Outstanding Equity Awards at Fiscal Year-End

The following table shows grants of options outstanding on June 30, 2008, the last day of our most recently completed fiscal year, to each of the Named Executive Officers named in the Summary Compensation Table. Information set forth herein gives effect to a 1 for 25 reverse stock split on December 11, 2008.

Table of Contents

Outstanding Equity Awards at Fiscal Year-End Table for the Fiscal Year Ended June 30, 2008

Option awards

Name **(a)**	**Number of securities underlying unexercised options (#) exercisable** **(b)**	**Number of securities underlying unexercised options (#) unexercisable** **(c)**	**Option exercise price ($)** **(e)**	**Option expiration date** **(f)**
Richard E. Forkey	11,208	3,736(1)	$ 13.75	5/9/2016
	14,944	0	$ 20.75	6/13/2015
Joseph N. Forkey	600	0	$ 13.75	5/9/2016
	8,406	2,802(1)	$ 13.75	6/13/2015
	22,416	0	$ 20.75	6/13/2015
Richard G. Cyr	6,200	4,000(2)	$ 13.75	5/9/2016

(1) These options will become exercisable on May 9, 2009.

(2) These options will become exercisable in equal installments on May 9, 2009, May 9, 2010 and May 9, 2011.

Narrative to Outstanding Equity Award Table

Option Grants in Last Fiscal Year

We made no individual grants of stock options to our Named Executive Officers during the fiscal year ended June 30, 2008.

Long Term Incentive Plans; Awards in Last Fiscal Year

We made no awards under any long-term incentive plan to our Named Executive Officers during the fiscal year ended June 30, 2008.

Profit Sharing and 401(k) Plan

We have a defined contribution 401(k) profit sharing plan. Employer profit sharing and matching contributions to the plan are discretionary. No employer profit sharing contributions were made to the plan in fiscal years 2008 and 2007. Employer matching contributions to the plan amounted to $17,473 and $42,325 for fiscal years 2008 and 2007, respectively.

Director Compensation

The following table sets forth all compensation paid to our directors during the fiscal year ended June 30, 2008. Information set forth herein gives effect to a 1 for 25 reverse stock split on December 11, 2008.

Director Compensation Table for the Fiscal Year Ended June 30, 2008

Name(1)	Fees earned or paid in cash ($)	Stock awards ($)	Option awards ($)	Non-equity incentive plan compensation ($)	Non-qualified deferred compensation earnings ($)	All other compensation ($)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Joel R. Pitlor	$ 4,500(2)	0	$ 2,852(4)(6)	0	0	$ 60,000(5)	$ 67,352
Donald A. Major	$ 11,750(2)(3)	0	$ 2,852(4)(7)	0	0	0	$ 14,602
Richard B. Miles	$ 4,750(2)	0	$ 2,852(4)(8)	0	0	0	$ 7,602

(1) This table does not include directors whose compensation is reflected in the summary compensation table.

(2) We pay each director, who is not also an employee of our Company, $250 per board or committee meeting that the director attends and reimburse the director for travel expenses.

(3) For his service to our Company, in his capacity as Chair of the Audit Committee, Mr. Major receives compensation of $500 per month, which is in addition to the standard compensation received by all members of the board of directors for their services.

(4) Each of Messrs. Major, Miles and Pitlor were issued options to purchase 400 shares of our common stock at our annual meeting in November 2007. These options were immediately exercisable at a price per share of $7.75, which was the closing price of our common stock on the Over-the-Counter Bulletin Board on the date of grant. These options will remain exercisable following a director s departure from service and expire on November 27, 2017. The amounts shown reflect the dollar amounts computed for financial statement reporting purposes for fiscal 2008 in accordance with the requirements of SFAS 123(R), excluding an estimate of forfeitures. Refer to Note 4, Stockholders Equity-Stock Options, in the Notes to the Consolidated Financial Statements included in our financial statements for

the fiscal year ended June 30, 2008, for the relevant assumptions used to determine the valuation of option awards.

(5) Mr. Pitlor is paid $60,000 per year, or $5,000 per month, for his services as a consultant to our Company. $25,000 of this amount has been deferred, and Mr. Pitlor has agreed that such fees may be paid in the form of our restricted common stock.

(6) As of June 30, 2008, Mr. Pitlor held a total of 1,578 options to purchase shares of our common stock.

(7) As of June 30, 2008, Mr. Major held a total of 1,600 options to purchase shares of our common stock.

(8) As of June 30, 2008, Mr. Miles held a total of 1,200 options to purchase shares of our common stock.

2006 Equity Incentive Plan

On November 28, 2006, our stockholders approved our 2006 Equity Incentive Plan, referred to as the 2006 Incentive Plan, which succeeds our Amended and Restated 1997 Equity Incentive Plan, referred to as the 1997 Incentive Plan. No further awards have been or will be granted under the 1997 Incentive Plan. Our board of directors had previously approved the 2006 Incentive Plan, subject to the approval of the stockholders. The 2006 Incentive Plan allows for the grant of stock options to selected employees, directors and other persons who provide services to our Company or our affiliates.

Compensation Committee Interlocks and Insider Participation

During the fiscal year ended June 30, 2008, Donald Major and Richard Miles served as members of our Compensation Committee. No member of our Compensation Committee at any time during the last fiscal year, or prior to the last fiscal year, was an officer or employee of our Company. Additionally, no member of our Compensation Committee had any relationship with us that would be required to be disclosed as a related person transaction. During the fiscal year ended June 30, 2008, none of our executive officers or employees participated in deliberations of our board of directors concerning executive officer compensation.

During the fiscal year ended June 30, 2008, none of our executive officers:

- served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire the board of directors) of another entity, one of whose executive officers served as a member of our Compensation Committee;

- served as a director of another entity, one of whose executive officers served as a member of our Compensation Committee; or

- served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire the board of directors) of another entity, one of whose executive officers served as a member of our board of directors.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information regarding our common stock owned as of the close of business on April 3, 2009 by the following persons: (i) each person who is known by us to own beneficially more than 5% of our common stock; (ii) each of our directors who beneficially own our or our subsidiaries common stock; (iii) each of our Named Executive Officers who beneficially own our or our subsidiaries common stock; and (iv) all executive officers and directors, as a group, who beneficially own our or our subsidiaries common stock. The information on beneficial ownership in the table and footnotes thereto is based upon data furnished to us by, or on behalf of, the persons listed in the table.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class (2)
AIGH Investment Partners, LLC 6006 Berkeley Avenue, Baltimore, MD 21209	/I>	

Bluehill ID s acquisition strategy has resulted in initial coverage of several important areas of the RFID value chain:

Market Segment	Bluehill ID s 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.
	Scolis Technology Center 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 the other members with RFID components.
	TagStar know how in the design and manufacture of RFID inlays for cards used in ski applications, event tickets and transportation tickets and passes.
Card Personalization / Secure Printing Houses	*Multicard* (Switzerland, Australia) 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 ID and corporate ID applications.
Readers	*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.
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.

Research and Development

To date, Bluehill ID has made substantial investments in research and development, particularly in the areas of inlays, readers, and software systems. In inlays, Bluehill ID is currently expanding its offerings with different antenna configurations and designs in high-frequency inlays and is conducting research and development activities in ultra high-frequency inlays. In the reader business, Bluehill ID is currently accelerating the development of new products, in particular, a next-generation ePassport reader, and multi-functional and ISO complaint smart card readers. In software, Bluehill ID s application software offerings are being expanded to not only include ID management but also to provide loyalty, ticketing, and transaction processing functions. Bluehill ID s 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. Bluehill ID also strives 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. Bluehill ID s future success will depend upon its 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 its customers.

Bluehill ID focuses the bulk of its research and development activities on the development of products for new and emerging market opportunities. Research and development capitalized and operating expenses were approximately $449,000 for the year ended December 31, 2008 (not including Bluehill ID corporate research and development overhead functions) and there were no research and development expenses for the year ended December 31, 2007, given the limited operations during that period. As of June 30, 2009, Bluehill ID had 22 full-time employees engaged in research and development activities, including software and hardware engineering, testing and quality assurance and technical documentation. The majority of Bluehill ID s research and development activities for smart card reader and ePassport reader products occur in Chennai, India, the majority of research and development activities for inlays occur in Sauerlach, Germany and for software systems in Villingen, Germany and Rotterdam, Netherlands.

Manufacturing and Sources of Supply

Bluehill ID utilizes the services of contract manufacturers in Germany and India to manufacture its smart card reader and ePassport reader products and components. Inlay products are generally assembled by TagStar s internal manufacturing organization, using locally and Far East sourced components. Bluehill ID has implemented a global sourcing strategy through ACiG Technology that it believes enables Bluehill ID to achieve economies of scale and uniform quality standards for its products, and to support gross margins. In the event any of Bluehill ID s contract manufacturers are unable or unwilling to continue to manufacture its products, Bluehill ID may have to rely on other current manufacturing sources or identify and qualify new contract manufacturers. Any significant delay in Bluehill ID s ability to obtain adequate supplies of its products from current or alternative sources would harm its business and operating results.

Bluehill ID believes that its success will depend in large part on its ability to provide quality products and services while ensuring the highest level of security for its products during the manufacturing process. Bluehill ID has formal quality control programs to satisfy its customers requirements for high quality and reliable products. To ensure that products manufactured by others are consistent with its standards, Bluehill ID manages all key aspects of the production process, including establishing product specifications, selecting the components to be used to produce its products, selecting the suppliers of these components and negotiating the prices for certain of these components. In addition, Bluehill ID works with its suppliers to improve process control and product design. As of June 30, 2009, Bluehill ID had 30 full-time employees engaged in manufacturing and logistics activities, focused on coordinating product management and supply chain activities between Bluehill ID and its contract manufacturers.

On an ongoing basis, Bluehill ID analyzes the need to add alternative sources for both its products and components. Even so, Bluehill ID relies upon a limited number of suppliers for some key components of its inlay and smart card reader products. For example, Bluehill ID currently utilizes external suppliers to produce chips and obtains antenna components from third-party suppliers in Asia.

Wherever possible, Bluehill ID has added additional sources of supply for these components. However, a risk remains that Bluehill ID may be adversely impacted by an inadequate supply of components, price increases, late deliveries or poor component quality. Additionally, components may not be available in a timely fashion or at all, particularly if larger companies have ordered more significant volumes of the components, and if demand is great, higher prices may be charged for components. Disruption or termination of the supply of components or software used in Bluehill ID s products could delay shipments of its products, which could have a material adverse effect on the Bluehill ID s business and operating results. These delays could also damage relationships with current and prospective customers.

Competition

The RFID identification and security markets are competitive and characterized by rapidly changing technology, as well as fragmentation of solutions providers. Bluehill ID believes that competition in these markets is likely to intensify as a result of anticipated increased demand for security and identification solutions. Bluehill ID currently experiences competition from two major sources: industry providers and investment companies.

The most significant competition comes from large industry players in both Europe and America, including: ASSA ABLOY Group, a manufacturer of RFID components and security solutions; Smartrac, a leading supplier of RFID inlays; KSW Microtec AG, one of the world s leading suppliers of RFID components and inlays for secure cards, documents and other form factors; Gemalto, a provider of diverse digital security solutions, and; Giesecke & Devrient, a leading supplier of banknote paper, banknote printing, currency automation systems, as well as smart cards and complex system solutions.

Bluehill ID also considers all industrial and investment companies pursuing consolidation strategies in the RFID sector with a similar business model to Bluehill ID to be competitors. A large number of companies are active in the classical investment business with emphasis on acquisition, holding and sale of companies. Additionally, private investors, venture capital companies, private equity firms, hedge funds and strategic investors can represent a competition to Bluehill ID 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.

While Bluehill ID believes that it competes favorably compared with its competitors in terms of return on investment, it may not be able to continue to successfully compete due to a variety of factors. Among these are the fact that large industry providers in particular may have greater financial resources than Bluehill ID, that some of these companies have product portfolios that are well established in the market and have greater access to sales and distribution channels. Competitive pressures Bluehill ID faces could materially and adversely affect Bluehill ID s business and operating results.

Proprietary Technology and Intellectual Property

Bluehill ID s success depends significantly upon its proprietary technology. Bluehill ID currently relies on a combination of patent, copyright and trademark laws, trade secrets, confidentiality agreements and contractual provisions to protect its proprietary rights, which afford only limited protection. Although Bluehill ID often seeks to protect its proprietary technology through patents, it is possible that no new patents will be issued, that Bluehill ID s proprietary products or technologies are not patentable, and that any issued patent will fail to provide Bluehill ID 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 Bluehill ID may be required to use litigation to protect its proprietary technology. This may result in Bluehill

ID incurring substantial costs and there is no assurance that Bluehill ID would be successful in any such litigation. Despite Bluehill ID s efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of its products or to use its 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 Bluehill ID s products are sold and a substantial portion of its business is conducted outside the U.S., Bluehill ID s exposure to intellectual property risks may be higher. Bluehill ID s means of protecting its proprietary and intellectual property rights may not be adequate. There is a risk that Bluehill ID s competitors will independently develop similar technology, duplicate its products or design around its patents or other intellectual property rights. If Bluehill ID is unsuccessful in protecting its intellectual property or its products or technologies are duplicated by others, its business could be harmed.

In addition, Bluehill ID may from time to time receive claims that it is 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 Bluehill ID. As the number of products and competitors in Bluehill ID s 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 Bluehill to redesign its products, accept product returns or to write off inventory. Any of these events could have a material adverse effect on Bluehill ID s business and operating results.

Bluehill ID owns approximately 12 patent families (designs, patents, utility models, and exclusive licenses) comprising a total of approximately 20 individual or regional filings, covering products, mechanical designs and ideas for its inlays, readers, and ID software businesses. None of Bluehill ID s patents are material to its business.

Backlog

Bluehill ID typically does 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. Bluehill ID s customer contracts generally do not require fixed long-term purchase commitments. In view of order and shipment patterns, and because of the possibility of customer changes in delivery schedules or cancellation of orders, Bluehill ID does not believe that such agreements provide meaningful backlog figures or are necessarily indicative of actual sales for any succeeding period.

Employees

As of June 30, 2009, Bluehill ID had 109 full-time employees, of which 22 were engaged in engineering, research and development; 24 were engaged in sales and marketing; 30 were engaged in manufacturing and logistics; and 33 were engaged in general management and administration. Bluehill ID is not subject to any collective bargaining agreements and, to Bluehill ID s knowledge, none of its employees are currently represented by a labor union. To date, Bluehill ID has experienced no work stoppages and believes that its employee relations are generally good.

International or Global Operations; Properties

Bluehill ID operates globally, with group headquarters in St. Gallen, Switzerland. Additionally, Bluehill ID s individual companies maintain facilities in Australia, Germany, the Netherlands, Switzerland, Sao Paulo, Brazil, Montreal, Canada and Miami, Florida. Bluehill ID also has a research and development facility in Chennai, India.

Legal Proceedings

From time to time, Bluehill ID 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, Bluehill ID s management expects that any such liabilities, to the extent not provided for by insurance or otherwise, will not have a material adverse effect on its financial condition, results of operations or cash flows.

BLUEHILL ID MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATION

The following discussion and analysis of Bluehill ID s financial condition and results of operations should be read together with Selected Historical and Pro Forma Combined Financial Data Selected Historical Financial Data of Bluehill ID and the Bluehill ID financial statements and related notes as well as the risk factors set forth under the caption Risks Relating to Bluehill ID s Business appearing elsewhere in this proxy statement and prospectus.

Company Overview

Bluehill ID is a Swiss industrial holding group for the acquisition of companies in the radio frequency identification (RFID)/identification and security industries. Bluehill ID targets controlling stakes in small to medium-sized companies in the RFID/identification and security space to support its buy, build and grow strategy on a global scale. Bluehill ID was registered in March 2007 in Switzerland and has traded on the Open Market of the Frankfurt Stock Exchange since December 2007 under the symbol BUQ. Bluehill ID was initially established as a fund structure and had arrangements with a separate management company, BH Capital Management AG, which received a percentage of Bluehill ID s profits and annual options. The services agreement with BH Capital Management AG was terminated effective as of July 1, 2009.

Bluehill ID Group Companies have a broad range of products and services spanning the RFID and smart card value chain including readers, transponders, inlays, smart cards and animal ID. Bluehill ID has a global customer base that includes governments, non-profit organizations and companies in many industries and applications that utilize cards and readers in loyalty programs, ticketing, stadiums, skiing, corporate identification, physical and logical access control, passport control, and other applications.

Bluehill ID Group Companies generally conduct their own sales and marketing activities in the market segments in which they compete in. Products are sold and supported through a combination of direct and indirect channels. 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. Bluehill ID Group Companies have direct sales staff that solicits prospective customers, provides technical advice and support with respect to its products and work closely with end customers, distributors, integrators and some OEMs. Bluehill ID Group Companies have the technical background, industry knowledge, and product expertise to assist the end user or dealer installer in the selection and application of solutions to meet their RFID/identification and security needs. Bluehill ID also provides technical support and training to its dealers and customers.

Bluehill ID sales address multiple market segments and Bluehill ID is not reliant on a single segment or single customer. Sales geographically are concentrated in Europe, Brazil, Australia, and, to a lesser extent, in Canada and the U.S.

Bluehill ID Group Companies sell products and solutions that span the RFID/identification and security value chains. Bluehill ID s brands have been grouped as follows: ACiG Technology, Arygon Technologies, Multicard, TagStar Systems and Syscan ID.

> ACiG Technology is an independent supplier and value added distributor of RFID and smart card integrated circuits, inlays, reader modules and other components.

Arygon is an early entrant and innovator in NFC/MIFARE RFID reader technology and related project services. Arygon manufactures advanced RFID reader modules for physical and logical access, transit and event ticketing, payment, government ID, industrial, medical and NFC applications and utilizes the development services of another Bluehill ID Group Company, SCOLIS, based in Chennai, India.

Multicard is a 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.

TagStar Systems is an RFID transponder manufacturer based in Germany and holds significant know-how in the design and manufacture of RFID inlays. Syscan ID is a producer of RFID ISO wand readers, also known as electronic ID readers (EID) for livestock. Syscan ID is centered on animal ID, traceability, country of origin labeling (COOL) and age verification, as well as in industrial applications where a durable RFID hand-held reader is needed.

Bluehill ID s predecessor companies are Multicard GmbH, Multicard AG and TagStar Systems GmbH. All three companies were acquired by Bluehill ID effective as of June 30, 2008 and marked Bluehill ID s first acquisitions. The three companies represent Bluehill ID s key focus areas of ID management and RFID and form the foundation of the Bluehill ID structure. The predecessor companies address strategic segments of the RFID and smart card value chain for Bluehill ID. Multicard GmbH and Multicard AG serve the ID management and integration markets and TagStar is an RFID transponder manufacturer. The Multicard brand has expanded globally and entered into the Netherlands and Australia. TagStar represents a significant area of technological innovation and development for the group and is demonstrating growth into new markets and investing in additional sales resources.

Bluehill ID prepares its consolidated financial statements in accordance with International Financial Reporting Standards (IFRS), as adopted by the International Accounting Standard Board (IASB). Results are reported in its principal currency, which is the Euro. On October 13, 2009, the prevailing exchange rate of U.S. dollars into Euros was 1.4886 U.S. dollars per Euro.

Industry Overview

Based upon its market research, Bluehill ID believes there are hundreds of companies in the RFID industry with revenues below the 5.0 million range, almost all of which are positioned with a single technology or focused on one single vertical market. The opportunities that exist in the RFID market include both possibilities to use the technology more broadly and in increasing numbers of applications, and the potential to build a global, market leading business that is capable of addressing multiple areas of the RFID value chain. RFID technology has the potential to address an array of higher value applications where providers can differentiate themselves while realizing higher revenue and profit returns. Addressing these higher value applications requires coordination between the different parts of the RFID value chain, and to date this is being addressed primarily by smaller companies on an ad hoc basis. This limits both the success of the individual players and the growth of the RFID market itself.

Bluehill ID Approach

To capitalize on the tremendous potential of the RFID/identification markets, Bluehill ID has since its inception successfully completed a significant number of acquisitions and subsequently integrated them into the company. Bluehill ID s goal is to become the signature company in identity management and RFID technologies across the globe. Bluehill ID actively supports its brands injecting industry know-how, management experience and capital for the companies to collaborate and be responsive to the changing customer demands rather than try to compete on a standalone basis offering niche products to local markets.

Bluehill ID expects the demand for identification in general and RFID in particular to continue to grow by 10-15% per year in value and expects these markets to be the significant driver of growth in its future business. The RFID, identification and security markets are competitive and characterized by rapidly changing technology as well as fragmentation of solutions providers. Bluehill ID believes that competition in these markets is likely to intensify as a result of anticipated increased demand for security and identification solutions. During fiscal year 2008, Bluehill ID strengthened and enhanced many of its head office functions including finance and accounting, marketing, project management and merger and acquisition capabilities to better position it to address current and future market opportunities.

Additionally, Bluehill ID believes that it can optimize the capital investment in manufacturing by its subsidiaries through the realization of synergies among the Bluehill ID Group Companies, such as higher volumes of transponders and readers as well as access to a wider technology base. Bluehill ID has benefited from synergies in several areas including technology, operational, branding, sales and marketing and general administration. Due to its continuing efforts in synergy extraction and increased collaboration across the Bluehill ID Group Companies, Bluehill ID expects that these activities will continue to benefit the operating performance of the company and increase profitability in the near future.

Critical Accounting Policies and Estimates

The discussion and analysis of results of operations and liquidity and capital resources are based on the Bluehill ID consolidated financial statements, which have been prepared in accordance with IFRS (as adopted by the IASB).

The preparation of these financial statements requires management to make estimates and judgments 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. Bluehill ID management bases their estimates on historical and anticipated results and trends and on various other assumptions that they believe are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. By their nature, estimates are subject to an inherent degree of uncertainty. Actual results may differ from those estimates.

The following represents a summary of Bluehill ID s critical accounting policies, defined as those policies that Bluehill ID management believes are: (a) the most important to the presentation of their financial condition and results of operations, and (b) that require management s judgment, often as a result of the need to make estimates about the matters that are inherently uncertain. The most critical accounting estimates include revenue recognition, valuation of inventories, valuation of investments, valuation of call options related to Bluehill ID and the valuation of deferred tax assets. Each of these policies is discussed below, as well as the estimates and judgments involved. There are also other policies that management considers key accounting policies; however, these policies do not meet the definition of critical accounting estimates, because they do not generally require management to make estimates or judgments that are difficult or subjective.

Revenue Recognition

Bluehill ID derives revenue from sales of products and services. Currently, over 90% of revenue is from sales of hardware. The following summarizes the major terms of the contractual relationships with customers and the manner in which Bluehill ID accounts for sales transactions.

Bluehill ID revenues arise from products that are manufactured, packaged, delivered and invoiced against specific customer orders. Bought-in products are similarly packaged, delivered and invoiced against specific customer orders. The risks and rewards are transferred to the customer at the time of delivery and invoicing and revenue is recognized at that time. Bluehill ID Group Companies currently have no long term contracts that require percentage completion revenue recognition. Revenue is recognized to the extent that it is probable that the economic benefits will flow to Bluehill ID and the revenue can be reliably measured. Revenue is measured at the fair value of the consideration received, excluding discounts, rebates, and sales taxes or duty. The following specific recognition criteria must also be met before revenue is recognized:

Sale of Goods. Hardware revenue consists of the sale of various hardware including the readers, transponders, smart cards, inlays and other identity management and RFID technologies.

Revenue from the sale of goods is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer, usually on delivery of the goods.

Interest Income. Revenue is recognized as interest accrues (using the effective interest method). Interest income is included in finance revenue in the income statement.

Service Revenue. Service revenue is generated from the sale of professional services. Generally, services revenue, which includes engineering services and consultancy services, is recognized upon delivery of the services, provided all other revenue recognition criteria noted above have been met. If the professional service project includes independent milestones, revenue is recognized as milestones are met and upon acceptance from the customer.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market, and consist primarily of raw materials, work-in-process and finished goods. Market is determined by comparison with recent sales or net realizable value.

Such net realizable value is based on management s forecasts for sales of Bluehill ID s products in the ensuing years. Bluehill ID operates in an industry characterized by technological change. Should the demand for Bluehill ID s products prove to be significantly less than anticipated, the ultimate realizable value of Bluehill ID s inventory could be substantially less than amounts in the accompanying balance sheets. Bluehill ID periodically reviews the age and turnover of its inventory to determine whether any inventory has become obsolete or has declined in value and records a charge to cost of revenues for known and estimated inventory obsolescence.

Financial Assets

Initial recognition. Financial assets within the scope of IAS 39 are classified as financial assets at fair value through profit or loss and loans and receivables. Bluehill ID determines the classification of its financial assets at initial recognition. Financial assets are recognized initially at fair value plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs.

Purchases or sales of financial assets that require delivery of assets within a time frame established by regulation or convention in the marketplace (regular way purchases) are recognized on the trade date such as, for example, the date that the company commits to purchase or sell the asset. Bluehill ID s financial assets include cash and short-term deposits, trade and other receivables, loan and other receivables, quoted and unquoted financial instruments.

Financial assets at fair value through profit or loss. Financial assets at fair value through profit or loss includes financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss. Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Financial assets at fair value through profit and loss are carried in the balance sheet at fair value with gains or losses recognized in the income statement.

Taxes

Current income tax. Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

Current income tax relating to items recognized directly in equity is recognized in equity and not in the income statement.

Deferred income tax. Deferred income tax is provided using the liability method on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

> where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
>
> in respect of taxable temporary differences associated with investments in subsidiaries, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognized for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry forward of unused tax credits and unused tax losses can be utilized except:

where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and in respect of deductible temporary differences associated with investments in subsidiaries, deferred income tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilized.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each balance sheet date and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date. Deferred income tax relating to items recognized directly in equity is recognized in equity and not in the income statement. Deferred income tax assets and deferred income tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

Valuation of Bluehill ID Call Options

As a result of the agreement to terminate a services agreement with BH Capital Management AG, a company controlled and owned by Ayman S. Ashour and Mountain Partners AG, which is an affiliate of Daniel S. Wenzel and Dr. Cornelius Boersch, a total of 3,914,790 call options for 3,914,790 shares of Bluehill ID AG were issued to BH Capital Management AG as compensation pursuant to the Call Option Agreement. This termination agreement included a change to the options already issued and all options issued have an exercise period of five years from June 2009. The strike price of all issued call options is CHF 1.00 per option. An early exercise of the option is possible anytime (American Options). The financial statements reflect the costs for these options. The average value per option is 0.3217 and this resulted in an additional 575,129 being charged to the Consolidated Income Statement in the six months ended June 30, 2009. Under the terms of the Business Combination Agreement with SCM, upon consummation of the business combination, these options are expected to be converted at the share exchange ratio into options to acquire shares of SCM.

Because the fair value of the received services cannot be reliably determined, the fair value of the granted equity instrument is used as a reference. The options are not directly tied to the length of service so the received services are entered at full value with an according change in equity. The fair value of the granted stock options at the time of provision is determined by using a binominal model according to Cox-Ross-Rubinstein. Volatility measure used was obtained by reference to comparable companies for a period equal in length to the period of the options.

The following parameters were used for calculating the value of the options:

Number of options in 2007 and 2008	2,526,500
Number of options in 2009	1,388,290
Issue Date	June 30, 2009
Duration	Five years
Expiration Date	June 30, 2014
Exercise Price	CHF 1
Share Price	CHF 1
Volatility	54.57%

Interest Rate	2.87%
Currency Exchange Rate (CHF-EUR)	0.6472

Business Combinations

Business combinations are accounted for using the purchase method of accounting. The cost of an acquisition is measured at fair value of the assets, given equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at fair values at the date of acquisition, irrespective of the extent of any minority interest.

Goodwill is initially measured at cost being the excess of the cost of the business combination over Bluehill ID s share in the net fair value of the acquiree s identifiable assets, liabilities and contingent liabilities. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognized directly in the income statement.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of Bluehill ID s cash generating units that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Results of Operations

Comparison of Six Months Ended June 30, 2009 and 2008

The following table sets forth Bluehill ID s net revenue, gross profit, and gross profit margin for the six months ended June 30, 2008 and June 30, 2009.

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Euros in thousands)	unaudited
Net revenue	7,017	0
Gross profit	3,037	0
Gross profit percentage	43.3%	N/A

Revenue

Net revenue for the six months ended June 30, 2009 was 7.0 million. During the six months ended June 30, 2008, Bluehill ID had not completed any acquisitions and therefore the net revenue was zero. The net revenue for the first six months of 2009 included six-months contribution from all the operating subsidiaries except for Fastcards which was acquired at the beginning of February 2009. A number of the subsidiaries have a seasonality in their sales that is heavily weighted to the second half of the year.

In the first six months of 2008, the predecessor companies (Multicard AG, Multicard GmbH and TagStar GmbH) had unaudited net revenues of 3.330 million.

During the first six months of 2009, the majority of Bluehill ID s revenue came from sales to a variety of customers in the commercial, industrial and government markets primarily in Europe and to a lesser extent in Brazil, Canada and Australia. Bluehill ID is starting to see the positive effects of the integration work done following the acquisitions which has resulted in improved performance from the operating companies. This includes using the widespread geographical presence of the Bluehill ID Group Companies to offer additional channels to market and common sourcing policies, in particular for silicon chips.

During the first six months of 2009, 52% of the net revenue was derived from the RFID Technology Products segment and 48% from the ID Integration and Services segment.

More than 65% of the net revenue is derived from companies operating in Euros, the Bluehill ID s reporting currency. In fiscal year 2008, the net revenue derived from companies operating in Euros was 53%.

Gross Profit

Bluehill ID s gross profit is calculated after charging the costs of materials used in manufacture. Gross profit for the six months ended June 30, 2009 was 3.0 million. The gross margin in the first six months of 2009 was 43.3%. There was no net revenue and no gross profit in the first six months of 2008 as there were no operating companies within the group at the time.

In the first six months of 2008, the predecessor companies (Multicard AG, Multicard GmbH and TagStar GmbH) had unaudited gross profit of 1.419 million (42.6%).

Gross margin in the RFID Technology Products segment was 34.4% and the gross margin in the ID Integration and Services segment was 55% in the first six months of 2008.

The gross profit of the acquired subsidiaries improved during the period following acquisition. Using the growing strength of the consolidated group, a number of key supply chain initiatives were launched to reduce the cost of materials, such as common sourcing and direct contract for the sourcing of silicon for the Bluehill ID Group Companies.

Factors that could affect gross profit in the future include competition, the volume of sales in any given quarter, product configuration and mix, the availability of new products and the cost and availability of components. Any one of these factors could create more variability in Bluehill ID gross profit than has historically been the case.

Operating Expenses

Research and Development.

Research and development (R&D) expenses consist primarily of employee compensation.

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Euros in thousands)	unaudited
R&D Expenses	278	0
Percentage of revenue	4%	N/A

Research and development expenses in the six months ended June 30, 2009 were 0.3 million, or 4% of revenue. There were no research and development expenses in the first six months of 2008.

Projects are in place to develop new products that address Bluehill ID s customers changing requirements and Bluehill ID expects to continue to make significant investments to enhance its product offerings using the development teams of Scolis in Chennai, India, TagStar in Germany and internal and external resources for Multicard companies in the Netherlands, Australia, Germany and Switzerland.

Selling, Marketing and General and Administrative.

Selling, marketing and general and administrative (SG&A) expenses consist primarily of employee compensation for the sales, marketing and general and administrative functions, expenses related to the running and administration of Bluehill ID as well as sales support, technical support, training and market development, as well as general facilities expenditures and professional fees arising from legal, auditing, investor relations and other consulting services.

	Six Months Ended	**Six Months Ended**
	June 30, 2009	**June 30, 2008**
	(Euros in thousands)	**unaudited**
Expenses	4,431	558
Percentage of revenue	63.2%	N/A

Total selling, marketing and general and administration expenses in the six months ended June 30, 2009 were 4.4 million, or 63.2% of revenue. The increase in the costs from the same period of 2008 was a result of the consolidation of the acquired subsidiaries, together with strengthening the Bluehill ID team in order to manage the further acquisition and organic growth of Bluehill ID.

Total selling, marketing and general and administration expenses in the six months ended June 30, 2008 was 0.6 million, representing the costs of Bluehill ID corporate only. There were no subsidiary company expenses in the first half of 2008.

Depreciation and Amortization.

Depreciation and amortization of intangible assets in the first six months of 2009 was 0.329 million. There was no depreciation and amortization of intangible assets in the first six months of 2008.

Other (Loss) Income.

Other expenses in the first six months of 2009 included 3.277 million for termination of the BH Capital Management AG services agreement. This is a one-time fee and the cancellation of the services agreement will reduce the expenses going forward. In addition, the costs of the options issued in connection with the services agreement and the termination agreement amounted to 0.6 million.

There was consolidated other income in the first six months of 2009 of 0.7 million resulting, principally, from reversal of impairment of a production machine at TagStar, together with taking to the income statement the excess of acquirer s interest in fair value of net assets. There was no other operating income or loss in the first six months of 2008 as no subsidiaries existed at that time.

The net financing costs in the first six months of 2009 amounted to 0.1 million. Net financing income in the first six months of 2008 was 0.2 million.

Income Taxes.

Income tax expense for Bluehill ID in the first six months of 2009 was 0.1 million. There was no income tax expense in the first half of 2008.

Comparison of Fiscal Years Ended December 31, 2008 and 2007

The following table sets forth Bluehill ID s net revenue, gross profit and gross profit margin for the twelve month periods ended December 31, 2007 and 2008.

	Year Ended December 31, 2008	Year Ended December 31, 2007
	(Euros in thousands)	unaudited
Net revenue	5,926	0
Gross profit	2,600	0
Gross profit percentage	43.9%	N/A

Revenue

Net revenue for the fiscal year ended December 31, 2008 was 5.9 million. Bluehill ID had no operating companies in 2007 and the net revenue in 2007 was therefore zero. The net revenue in 2008 derived from six months contribution from TagStar, Multicard GmbH and Multicard AG together with three months contribution from ACiG Technology in Brazil together with its subsidiary in the USA.

Bluehill ID was formed in 2007 and began trading over-the-counter (Open Market) at the Frankfurt Stock Exchange in December 2007. The activities of Bluehill ID until the end of the first half of 2008 were primarily focused on fund raising, recruitment, accomplishing the approval of a German prospectus, and targeting of acquisitions and negotiations for the company s first acquisitions (which were completed at the end of June 2008).

During fiscal year 2008, 65% of the net revenue was derived from the RFID Technology Products segment and 35% from the ID Integration and Services segment.

Gross Profit

Bluehill ID s gross profit is calculated after charging the costs of materials used in manufacture. Gross profit for fiscal year 2008 was 2.6 million. The gross margin percentage in 2008 was 43.9%. Bluehill ID had no operations in 2007 and, therefore, there was no gross profit in 2007.

The gross profit of the acquired subsidiaries improved during the period following acquisition. Using the growing strength of Bluehill ID, a number of key supply chain initiatives were launched to reduce the cost of materials, such as common sourcing and direct contract for the sourcing of silicon for the Bluehill ID Group Companies.

Factors that could affect gross profit in the future include competition, the volume of sales in any given quarter, product configuration and mix, the availability of new products and the cost and availability of components. Any one of these factors could create more variability in Bluehill ID gross profit than has historically been seen.

Gross margin in the RFID Technology Products segment was 32% and gross margin in the ID Integration and Services segment was 64% in fiscal year 2008.

In fiscal year 2008, 53% of the net revenue was derived from Bluehill ID companies operating in Euros, Bluehill ID s reporting currency.

Operating Expenses

Research and Development.

Research and development (R&D) expenses consist primarily of employee compensation.

	Year Ended December 31, 2008	**Year Ended December 31, 2007**
	(Euros in thousands)	**unaudited**
R&D Expenses	179	0
Percentage of revenue	3%	

Research and development expenses in fiscal year 2008 were 0.2 million, or 3% of revenue. There were no research and development expenses in fiscal year 2007.

Projects are in place to develop new products that address Bluehill ID s customers changing requirements and Bluehill ID expects to continue to make significant investments to enhance its product offerings using the development teams at subsidiary companies and other resources both inside and external to Bluehill ID.

Selling, Marketing and General and Administrative

Selling, marketing and general and administrative (SG&A) expenses consist primarily of fees paid to BH Capital Management, AG, the initial management company of Bluehill ID, as well as advisory, banking and other legal costs for prospectus approval, stock listing and for employee compensation for the sales, marketing and general and administrative functions, expenses related to sales support, technical support, training and market development, as well as general facilities expenditures and professional fees arising from legal, auditing and other consulting services.

	Year Ended	**Year Ended**
		December 31,
	December 31, 2008	**2007**
	(Euros in thousands)	**unaudited**
Expenses	3890	712
Percentage of revenue	66%	n/a

Total selling, marketing and general and administration expenses in fiscal year ended December 31, 2008 were 3.9 million, or 66% of revenue. While contributions from operations were only for part of the year, Bluehill ID corporate expenses were for the full year.

Total selling, marketing and general and administration expenses in fiscal year ended December 31, 2007 were 0.7 million, representing the costs of the Bluehill ID corporate team including fees paid to BH Capital Management that had been established to start the acquisition process and manage Bluehill ID.

Depreciation and Amortization.

Depreciation and amortization of intangible assets was 0.2 million in fiscal year 2008 and zero in fiscal year 2007.

Other (Loss) Income.

Fiscal year 2008 included other income of 0.7 million arising, principally, from the excess of acquirer s interest in fair value of net assets, over cost, taken to the income statement. There was no other income or loss in fiscal year 2007.

Fiscal year 2008 included net finance income of 1.4 million arising from net interest income (0.1 million), net foreign exchange gains (0.5) and net gains of financial assets at fair value through profit or loss (0.8 million). Fiscal year 2007 included net finance income of 0.1 million arising from net interest income.

Income Taxes.

Net tax income for Bluehill ID in 2008 was 4,000. There was no income tax expense in 2007.

Liquidity and Capital Resources

As of June 30, 2009, Bluehill ID had 3.2 million of cash and short term deposits. As of December 31, 2008, Bluehill ID had 7.7 million of cash and short-term deposits. The changes resulted from cash used in acquisitions (0.7 million), cash used in increasing the stakes in minority investments (1.6 million) and cash used in support of operations (3.2 million) together with net cash receipts from capital increase (1.0 million). The cash used to support operations increased as a result of growth in Bluehill ID s corporate operations necessary to support a significantly larger group of companies as well as to support the expected future acquisitions.

In order to fund continued acquisitions and support its growth plans, Bluehill ID expects to continue to require additional capital. Historical capital increases include both cash increases and contributions in kind. Bluehill ID intends to secure the necessary capital to fund its strategy through sales of its debt or equity securities, bank loans or third-party financing. Any financing is subject to favorable terms and market conditions and there can be no assurance that Bluehill ID will be able to secure the necessary funds for a proposed acquisition or other capital requirements. Bluehill ID actively uses its own shares as financing currency for the acquisitions and in fact will use shares as currency whenever possible to limit cash utilization. This encourages employee ownership and shares allow them to benefit from the growth of the company as part of their overall compensation.

Off-Balance Sheet Arrangements

Bluehill ID has not entered into off-balance sheet arrangements or issued guarantees to third parties.

Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

There have been no changes in, and Bluehill ID has had no disagreements with, its accountants with respect to its accounting and financial disclosure.

Quantitative and Qualitative Disclosures About Market Risk

Foreign Currencies

Bluehill ID s consolidated financial statements are presented in Euros, which is the company s functional currency. That is the currency of the primary economic environment in which Bluehill ID operates. Each entity in the Bluehill ID group of companies determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. Transactions in foreign currencies are initially recorded at the functional currency rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency spot rate of exchange ruling at the balance sheet date. All differences are taken to the income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value is determined.

The assets and liabilities of foreign operations are translated into Euros at the rate of exchange prevailing at the balance sheet date and their income statements in general are translated at exchange rates prevailing at the date of the transactions. If the exchange rates for the translation of the income statement are not directly attributable to the transaction, Bluehill ID has used the average of the exchange rates for the period ending December 31, 2008. The exchange differences arising on the translation are taken directly to a separate component of equity.

Fiscal year 2008 IFRS financial statements disclosure notes included a sensitivity analysis of exposure to exchange rate (Note 23 Financial risk management objectives and policies).

Fixed Income Investments

Bluehill ID does not use derivative financial instruments in its investment portfolio.

Material Differences Between IFRS and U.S. GAAP for Fiscal Year 2008

There were no differences in the 2008 fiscal year in revenues under IFRS and U.S. GAAP resulting from differences in treatment of revenue recognition.

The most significant reconciling items between the IFRS and U.S. GAAP pro forma financial statements were principally related to the difference in treatment of leased vehicles, pensions, intangibles and deferred taxes.

The net effect of these differences on Total Assets in the pro forma U.S. GAAP balance sheet was a reduction of 0.1 million compared to the IFRS statements.

The net effect of these differences on the pro forma income statement was an increase of net profit of 15,000.

Material Differences Between IFRS and U.S. GAAP for the Six Months Ended June 30, 2009

There were no differences in the six months ended June 30, 2009 in revenues under IFRS and U.S. GAAP resulting from differences in treatment of revenue recognition.

The most significant reconciling items between the IFRS and U.S. GAAP pro forma financial statements were principally related to the difference in treatment of leased vehicles, reversal of impairment of fixed asset, pensions, intangibles and deferred taxes.

The net effect of these differences on Total Assets in the pro forma U.S. GAAP balance sheet was a reduction of 0.4 million compared to the IFRS statements.

The net effect of these differences on the pro forma income statement was an increase of net profit of 0.3 million.

DESCRIPTION OF SCM MICROSYSTEMS CAPITAL STOCK

Authorized Capital

As of September 30, 2009, the authorized capital stock of SCM consists of 40,000,000 shares of SCM common stock, $0.001 par value, and 10,000,000 shares of preferred stock, $0.001 par value. At SCM s 2009 Annual Meeting of Stockholders, which is being held on October 29, 2009, SCM s stockholders are voting upon a proposal to increase the number of shares of SCM common stock authorized for issuance by 20,000,000 shares, to an aggregate of 60,000,000 shares.

Common Stock

As of September 30, 2009, there were 25,134,985 shares of SCM common stock outstanding. Holders of SCM common stock are entitled to one vote per share on all matters to be voted upon by the stockholders. Subject to preferences that may be applicable to any outstanding SCM preferred stock, the holders of SCM common stock are entitled to receive ratably such dividends, if any, as may be declared from time to time by SCM s board of directors out of funds legally available therefor. In the event of a liquidation, dissolution or winding up of SCM, the holders of SCM common stock are entitled to share ratably in all assets remaining after payment of liabilities, subject to prior liquidation rights of SCM preferred stock, if any, then outstanding. The SCM common stock has no preemptive or conversion rights or other subscription rights. There are no redemption or sinking fund provisions applicable to the SCM common stock. All outstanding shares of SCM common stock are fully paid and non-assessable, and the shares of SCM common stock to be outstanding upon consummation of the offering will be fully paid and non-assessable.

Preferred Stock

As of September 30, 2009, 10,000,000 shares of undesignated SCM preferred stock were authorized, and no shares were outstanding. SCM s board of directors has the authority to issue the shares of SCM preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions granted to or imposed upon any unissued shares of preferred stock and to fix the number of shares constituting any series and the designations of such series, without any further vote or action by the stockholders. Although it presently has no intention to do so, SCM s board of directors, without stockholder approval, can issue preferred stock with voting and conversion rights which could adversely affect the voting power of the holders of SCM common stock. The issuance of SCM preferred stock may have the effect of delaying, deterring or preventing a change in control of SCM.

Warrants

As of September 30, 2009, warrants to purchase approximately 4,900,807 million shares of SCM common stock were outstanding.

Options

As of June 30, 2009, an aggregate of approximately 2.9 million shares of SCM common stock were reserved for future issuance under all of SCM s stock option plans, of which 2.4 million shares were subject to outstanding options. At SCM s 2009 Annual Meeting of Stockholders, which is being held on October 29, 2009, SCM s stockholders are voting upon a proposal to increase the number of shares of SCM common stock which may be granted under the 2007 Stock Option Plan by an additional 2,000,000 shares, to an aggregate of 3,500,000 shares.

Rights Agent; Transfer Agent; Anti-Takeover Provisions

American Stock Transfer & Trust Company is the transfer agent and registrar for SCM common stock, and rights agent in connection with the rights agreement, as amended, between SCM and American Stock Transfer & Trust Company. For more information on the rights agreement, see the section entitled Certain Agreements Related to the Offer Amendment to Rights Agreement.

In addition, certain provisions of SCM s certificate of incorporation and bylaws may be deemed to have an anti-takeover effect. For a more complete discussion of these anti-takeover provisions, see the section entitled Comparison of SCM Microsystems Stockholders and Bluehill ID Shareholders Rights and Corporate Governance Matters Anti-Takeover Provisions.

DESCRIPTION OF BLUEHILL ID CAPITAL STOCK

Issued and Outstanding Share Capital

As of October 1, 2009, Bluehill ID s issued and outstanding share capital currently amounts to CHF 32,023,797, consisting of 32,023,797 bearer shares with a nominal value of CHF 1.00 each, including 173,768 bearer shares in Bluehill ID currently held in treasury. For more information about the authorized capital of Bluehill ID see the section entitled, Comparison of SCM Microsystems Stockholders and Bluehill ID Shareholders Rights and Corporate Governance Matters.

Potential Future Issuances

Bluehill ID has authorized and implemented the Bluehill ID Option Plans, which consist of an executive share option plan and an executive bonus plan. Bluehill ID has a conditional share capital under which up to 4,000,000 bearer shares in Bluehill ID may be issued in connection with the Bluehill ID Option Plans. As of October 1, 2009, no options or awards had been issued or granted under the Bluehill ID Option Plans but some options may be granted in the future upon the achievement of certain performance targets pursuant to the terms of existing employment agreements as described in this proxy statement and prospectus. Options and other awards under the Bluehill ID Option Plans can only be granted within 60 days from publication of audited annual report of Bluehill ID, which is expected to be no earlier than May 15, 2010.

Bluehill ID has granted to BH Capital Management AG, a company controlled and owned by Ayman S. Ashour and Mountain Partners AG, which is an affiliate of Daniel S. Wenzel and Dr. Cornelius Boersch, an option to purchase up to 3,914,790 bearer shares in Bluehill ID at an exercise price of CHF 1.00 per share until June 30, 2014 pursuant to the Call Option Agreement.

Former shareholders of subsidiaries of Bluehill ID, including Yoonison BV, ACiG AG, TagStar Systems GMBH and Multicard AG & GMBH, are parties to the Earn Out Agreements, pursuant to which bearer shares in Bluehill ID are issuable to the former shareholders upon the achievement of specified performance targets based on Bluehill ID s sales and profits before taxes for 2009 and 2010. If all such targets are achieved, bearer shares in Bluehill with a value of 482,000 would be issuable with respect to 2009 and 422,000 would be issuable with respect to 2010, in each case within 60 days of the release of annual results for Bluehill ID. The actual number of bearer shares in Bluehill ID that are issuable under the Earn Out Agreements will be based on the average trading price of a bearer share in Bluehill ID during the month prior to issuance. Based on an average price per share of a bearer share in Bluehill ID during the month of September 2009 of 0.77818, up to an aggregate of 1,161,685 bearer shares in Bluehill ID could be issuable under the Earn Out Agreements.

For more information regarding the treatment of the Bluehill ID options and other rights to acquire or receive bearer shares in Bluehill ID, see the section entitled The Offer Treatment of Options in this proxy statement and prospectus.

PRINCIPAL STOCKHOLDERS OF SCM MICROSYSTEMS

The following table and the related notes present information as of September 30, 2009 with respect to the beneficial ownership of shares of SCM common stock prior to the Offer and the expected beneficial ownership of shares of SCM common stock following the Offer by (i) each current director and named executive officer of SCM, (ii) each person or group who is known to the management of SCM to be the beneficial owner of more than 5% of all shares of SCM voting securities outstanding as of September 30, 2009 and (iii) all current directors and current executive officers of SCM, as a group. Unless otherwise indicated in the footnotes to the table below and subject to applicable community property laws, SCM believes that each of the stockholders named in the table below has sole voting and investment power with respect to the shares indicated as beneficially owned.

As of September 30, 2009, there were 25,134,985 shares of SCM common stock issued and outstanding. Following the Offer, assuming that SCM acquires 100% of the currently issued and outstanding bearer shares in Bluehill ID and that no options to purchase bearer shares in Bluehill ID are exercised, including under the Call Option Agreement, there are expected to be 40,495,996 shares of SCM common stock issued and outstanding, excluding the 1,201,004 shares of SCM common stock currently held by Bluehill ID. Immediately following the closing of the Offer, these shares are expected to continue to be held by Bluehill ID, but SCM may be deemed to be the beneficial owner of these shares through its interest in Bluehill ID. Therefore, following the Offer, these shares have been excluded from the number of shares of SCM common stock outstanding in the table below. Following the closing of the Offer, the board of directors of Bluehill ID may determine to sell these shares on terms to be determined by the board, including to a transferee that may be an affiliate of SCM or Bluehill ID or one of their respective officers or directors.

Shares of SCM common stock subject to options and warrants that are currently exercisable or are exercisable within 60 days of September 30, 2009 and bearer shares in Bluehill ID subject to options or other rights that are currently exercisable or are exercisable within 60 days of October 1, 2009, are treated as outstanding and beneficially owned by the person holding them for the purpose of computing the percentage ownership of that person, but are not treated as outstanding for the purpose of computing the percentage of beneficial ownership of any other shareholder. The figures in this paragraph and in the table below assume no exercise or termination of any options to purchase SCM common stock or any of the options or other rights to purchase or receive bearer shares in Bluehill ID (including options under the Call Option Agreement), and assumes the conversion of the options or other rights to purchase or receive bearer shares in Bluehill ID into options or other rights to purchase or receive shares of SCM common stock in connection with the Offer.

Unless specified otherwise below, the mailing address for each individual, officer or director is c/o SCM Microsystems, Inc., 1900-B Carnegie Ave., Santa Ana, California 92705.

Shares of SCM Common Stock Beneficially Owned

	Prior to the Offer		Following the Offer	
Name of Beneficial Owner	**Total Beneficial Ownership**	**Approximate Percentage**	**Total Beneficial Ownership**	**Approximate Percentage**
Lincoln Vale European Partners Master Fund, LP(1)	1,545,692	6.1%	3,162,239	7.8%
Grand Pavilion Commercial Center, 802 West Bay Road, PO Box 30599, Grand Cayman, KY1-1203, Cayman Islands				
Ayman S. Ashour(2)	1,305,004	5.2%	4,591,344	10.8%
Dufourstrasse 121, St. Gallen, Switzerland CH-9001				
Royce & Associates, LLC(3)	1,261,880	5.0%	1,261,880	3.1%
1414 Avenue of the Americas New York, NY 10019				
Bluehill ID AG(4)	1,201,004	4.8%		
Dufourstrasse 121, St. Gallen, Switzerland CH-9001				
Dimensional Fund Advisors, Inc.(5)	1,165,213	4.6%	1,165,213	2.9%
Palisades West, Building One 6300 Bee Cave Road Austin, Texas 78746				
Dr. Hans Liebler(6)	1,555,692	6.2%	3,172,239	7.8%
Lawrence W. Midland(7)	1,257,600	5.0%	1,309,600	3.2%
Douglas J. Morgan(8)	275,208	1.1%	275,208	*
Stephan Rohaly(9)	129,215	*	129,215	*
Manfred Mueller(10)	113,387	*	113,387	*
Steven Humphreys(11)	108,194	*	108,194	*
Werner Koepf(12)	65,081	*	65,081	*
Simon Turner(13)	55,700	*	55,700	*
Felix Marx(14)	39,086	*	39,086	*
Martin Wimmer(15)	19,812	*	19,812	*
All directors and executive officers as a group before the Offer (10 persons)(16)	3,618,975	14.2%	5,235.522	12.9%

* Indicates ownership of less than one percent.

(1) Based solely on information contained in an Annual Report on Form 10-K, as filed with the Securities and Exchange Commission by Lincoln Vale LLC on March 13, 2009. Following the Offer includes 1,616,547 shares of SCM common stock expected to be received by Lincoln Vale pursuant to the Offer in exchange for 3,108,744 bearer shares in Bluehill ID that it currently holds.

(2) Based on information provided by Ayman S. Ashour to SCM. Ayman S. Ashour is the Chief Executive Officer and Chairman of Bluehill ID. Mr. Ashour, jointly with his wife, directly owns 104,000 shares of SCM common stock. Prior to the Offer includes 1,201,004 shares of SCM common stock currently held by Bluehill ID. Following the Offer, these shares have been excluded from the number of shares of SCM common stock outstanding. Mr. Ashour disclaims beneficial ownership of all shares of SCM common stock not held directly by him or jointly with his wife. Following the Offer also includes (i) 208,000 shares of SCM common stock expected to be received by Mr. Ashour pursuant to the Offer in exchange for 400,000 bearer shares in Bluehill ID that Mr. Ashour currently directly holds or controls and (ii) 4,383,344 shares of SCM common stock representing 4,314,718 bearer shares of Bluehill ID and currently exercisable options to acquire

3,914,790 shares bearer shares of Bluehill ID that are held by BH Capital Management AG, of which Mr. Ashour is a 49% shareholder and member of the board of directors. Mr. Ashour disclaims beneficial ownership of all of the bearer shares in Bluehill ID and options to acquire bearer shares in Bluehill ID held by BH Capital Management AG, except to the extent of his pecuniary interest therein. Mr. Ashour also holds warrants to purchase 52,000 shares of SCM common stock, which are not exercisable until April 30, 2012 and are therefore not included in the table above.

(3) Based solely on information contained in a Schedule 13-F filed with the Securities and Exchange Commission for the period ended June 30, 2009.

(4) Shares of SCM common stock currently held by Bluehill ID. Following the Offer, these shares have been excluded from the number of shares of SCM common stock outstanding.

(5) Based solely on information contained in a Schedule 13-F filed with the Securities and Exchange Commission for the period ended June 30, 2009.

(6) Prior to the Offer includes options to purchase 10,000 shares of SCM common stock exercisable within 60 days and 1,545,692 shares of SCM common stock held by Lincoln Vale. Following the Offer also includes 1,616,547 shares of SCM common stock expected to be received by Lincoln Vale pursuant to the Offer in exchange for 3,108,744 bearer shares in Bluehill ID that it currently holds. Dr. Liebler is a founder and member of the investment committee of Lincoln Vale. As a result of his affiliation with Lincoln Vale, Dr. Liebler may be deemed to beneficially own the shares of SCM common stock and bearer shares in Bluehill held by Lincoln Vale and may have shared voting and investment power with respect to such shares. Dr. Liebler disclaims beneficial ownership of or any pecuniary interest in such shares.

(7) Includes 1,239,600 shares of SCM common stock held by the Midland Family Trust Est. Jan 29, 2002, 5,200 shares of SCM common stock held by Mr. Midland as custodian for Ashley Marie Midland, 6,000 shares of SCM common stock held as custodian for Alison Midland, 4,000 shares of SCM common stock held as custodian for Taylor Ann Midland and 2,800 shares of SCM common stock held as custodian for Madison Kathleen Midland. Following the Offer also includes 52,000 shares in shares of SCM common stock expected to be received by Mr. Midland pursuant to the Offer in exchange for 100,000 bearer shares in Bluehill ID that Mr. Midland currently holds. Mr. Midland also beneficially owns warrants to purchase 628,800 of SCM common stock, which are not exercisable until April 30, 2012, and options to purchase 40,000 shares of SCM common stock, which are not exercisable within 60 days, and are therefore not included in the table above.

(8) Includes options to purchase 4,166 shares of SCM common stock exercisable within 60 days. Mr. Morgan also holds warrants to purchase 152,950 shares of SCM common stock, which are not exercisable until April 30, 2012 and are therefore not included in the table above. Of the shares beneficially owned by Mr. Morgan, 50,000 are held by Performance Strategies Inc. Profit Sharing Plan & Trust, of which Mr. Morgan is a trustee. In addition, of the warrants to purchase shares of SCM stock, 25,000 are held by Performance Strategies Inc. Profit Sharing Plan & Trust.

(9) Includes options to purchase 106,550 shares of SCM common stock exercisable within 60 days. Mr. Rohaly resigned from SCM effective September 30, 2009.

(10) Includes options to purchase 93,348 shares of SCM common stock exercisable within 60 days.

(11) Includes options to purchase 56,415 shares of SCM common stock exercisable within 60 days.

(12) Includes options to purchase 25,000 shares of SCM common stock exercisable within 60 days.

(13) Includes options to purchase 50,000 shares of SCM common stock exercisable within 60 days.

(14) Consists of options to purchase of 37,425 shares of SCM common stock exercisable within 60 days.

(15) Consists of options to purchase 19,436 shares of SCM common stock exercisable within 60 days. Mr. Wimmer was appointed to serve as interim Chief Financial Officer on September 23, 2009, with such appointment effective September 30, 2009.

(16) Includes an aggregate of 402,340 options exercisable within 60 days. In addition, includes 1,545,692 shares of SCM common stock held by Lincoln Vale and following the Offer includes 1,616,547 shares of SCM common stock expected to be received by Lincoln Vale pursuant to the Offer in exchange for 3,108,744 bearer shares in Bluehill ID that it currently holds. See footnote 6 above.

PRINCIPAL SHAREHOLDERS OF BLUEHILL ID

The following table and the related notes present information known to Bluehill ID as of October 1, 2009 with respect to the beneficial ownership of the bearer shares in Bluehill ID prior to the Offer and the expected beneficial ownership of shares of SCM common stock following the Offer, by (i) each current director and named executive officer of Bluehill ID, (ii) each person or group who is known to the management of Bluehill ID to be the beneficial owner of more than 5% of all shares of Bluehill ID voting securities outstanding as of October 1, 2009 and (iii) all current directors and current executive officers of Bluehill ID, as a group. Unless otherwise indicated in the footnotes to the table below and subject to applicable community property rules, Bluehill ID believes that each of the shareholders named in the table below has sole voting and investment power with respect to the shares indicated as beneficially owned.

As of October 1, 2009, there were 31,850,029 bearer shares in Bluehill ID issued and outstanding, excluding 173,768 bearer shares in Bluehill ID held in treasury. As of September 30, 2009, there were 25,134,985 shares of SCM common stock issued and outstanding. Following the Offer, assuming that SCM acquires 100% of the currently issued and outstanding bearer shares in Bluehill ID and that no options to purchase bearer shares in Bluehill ID are exercised, including under the Call Option Agreement, there are expected to be 40,495,996 shares of SCM common stock issued and outstanding, excluding the 1,201,004 shares of SCM common stock currently held by Bluehill ID. Immediately following the closing of the Offer, these shares are expected to continue to be held by Bluehill ID, but SCM may be deemed to be the beneficial owner of these shares through its interest in Bluehill ID. Therefore, following the Offer, these shares have been excluded from the number of shares of SCM common stock outstanding in the table below. Following the closing of the Offer, the board of directors of Bluehill ID may determine to sell these shares on terms to be determined by the board, including to a transferee that may be an affiliate of SCM or Bluehill ID or one of their respective officers or directors.

Bearer shares in Bluehill ID subject to options or other rights that are currently exercisable or are exercisable within 60 days of October 1, 2009 and shares of SCM common stock subject to options and warrants that are currently exercisable or are exercisable within 60 days of September 30, 2009 are treated as outstanding and beneficially owned by the person holding them for the purpose of computing the percentage ownership of that person, but are not treated as outstanding for the purpose of computing the percentage of beneficial ownership of any other shareholder. The figures in this paragraph and in the table assume no exercise or termination of any of the options or other rights to purchase or receive bearer shares in Bluehill ID (including options under the Call Option Agreement) or any options or other rights to purchase SCM common stock, and assumes the conversion of the options and other rights to purchase or receive bearer shares in Bluehill ID into options or other rights to purchase or receive shares of SCM common stock in connection with the Offer.

Unless specified otherwise below, the mailing address for each individual, officer or director is c/o Bluehill ID AG, Dufourstrasse 121, St. Gallen, Switzerland, CH-9001.

Shares Beneficially Owned

	Prior to the Offer (Bearer Shares in Bluehill ID)				**Following the Offer (SCM Common Stock)**	
Name of Beneficial Owner	**Number of Shares Held Directly**	**Number of Shares Held Indirectly**	**Total Beneficial Ownership**	**Approximate Percentage**	**Total Beneficial Ownership**	**Approximate Percentage**
Ayman S. Ashour(1)	400,000	8,229,508	8,629,508	24.1%	4,591,344	10.8%
Werner Vogt	873,690		873,690	2.7%	454,319	1.1%
Daniel S. Wenzel(2)	13,250	20,561,120	20,574,370	57.5%	10,698,672	25.2%
Dr. Cornelius Boersch(3)	57,308	19,070,751	19,128,059	53.5%	9,946,591	23.4%
Mountain Partners AG(4)	8,771,880	10,298,871	19,070,751	53.3%	9,916,791	23.3%
BH Capital Management AG(5)	8,229,508		8,229,508	23.0%	4,279,344	10.1%
Lincoln Vale European Partners Master Fund L.P.(6) Grand Pavilion Commercial Center, 802 West Bay Road, PO Box 30599, Grand Cayman, KY1-1203, Cayman Islands	3,108,744		3,108,744	9.8%	3,162,239	7.8%
Stanford Venture Capital Holdings, Inc. 6075 Popular Avenue, 3rd Floor, Memphis, TN, 98119	2,226,666		2,226,666	7.0%	1,157,866	2.9%
Mountain Super Angel AG(7)	2,069,363		2,069,363	6.5%	1,076,069	2.7%
www.heymountain.com GmbH HEYMOUNTAIN COSMETICS Harthoefe 14, 72362 Nusplingen, Germany	1,665,000		1,665,000	5.2%	865,800	2.1%
Melvin Denton-Thompson	128,069		128,069	*	66,596	*
Joseph Tassone	84,000		84,000	*	43,680	*
Fabien Nestmann	32,250		32,250	*	16,770	*
John Rogers	25,000		25,000	*	13,000	*
Directors and officers of Bluehill ID as a group (8 persons)(8)	1,613,567	20,561,120	22,174,687	62.0%	11,634,837	27.4%

* Indicates ownership of less than 1%

(1) Mr. Ashour directly holds or controls 400,000 bearer shares in Bluehill ID. Mr. Ashour s indirect holdings include 4,314,718 bearer shares of Bluehill ID and currently exercisable options to acquire 3,914,790 shares bearer shares of Bluehill ID that are held by BH Capital Management AG, of which Mr. Ashour is a 49% shareholder

and member of the board of directors. Mr. Ashour disclaims beneficial ownership of all of the bearer shares in Bluehill ID and options to acquire bearer shares in Bluehill ID held by BH Capital Management AG, except to the extent of his pecuniary interest therein. Following the Offer also includes the 104,000 shares of SCM common stock that Mr. Ashour, jointly with his wife, owns directly. Mr. Ashour also holds warrants to purchase 52,000 shares of SCM common stock, which are not exercisable until April 30, 2012 and are therefore not included in the table above. Excludes 1,201,004 shares of SCM common stock currently held by Bluehill ID, which following the Offer will be excluded from the number of shares of SCM common stock outstanding. Mr. Ashour disclaims beneficial ownership of all shares of SCM common stock not held directly by him or jointly with his wife.

(2) Mr. Wenzel directly holds 13,250 bearer shares in Bluehill ID. Mr. Wenzel s indirect holdings include 20,561,120 bearer shares in Bluehill ID held directly by the following entities of which Mr. Wenzel is a member of the respective board of directors: (i) Mountain Partners AG, 8,771,880 shares; (ii) Mountain Super Angel AG, 2,069,363 shares; (iii) Rosenberg Venture AG, 1,490,369 shares; and (iv) BH Capital Management AG, 4,314,718 shares and currently exercisable options to acquire 3,914,790 shares. Mr. Wenzel disclaims beneficial ownership of the bearer shares in Bluehill ID held or beneficially owned by Mountain Partners AG,

Mountain Super Angel AG, Rosenberg Venture AG and BH Capital Management AG, except to the extent of his pecuniary interest in each such entity. Mr. Wenzel is one of many directors on the board of directors of each of Mountain Partners AG and Mountain Super Angel AG, and he does not have sole voting or dispositive control over the shares held by such entities.

(3) Dr. Boersch directly holds 57,308 bearer shares in Bluehill ID. Dr. Boersch s indirect holdings include 19,070,751 bearer shares in Bluehill ID held directly or indirectly by Mountain Partners AG, of which Dr. Boersch is a member of the board of directors. Dr. Boersch disclaims beneficial ownership of the bearer shares in Bluehill ID held or beneficially owned by Mountain Partners AG, except to the extent of his pecuniary interest in such entity. Dr. Boersch is one of many directors on the board of directors of Mountain Partners AG and he does not have sole voting or dispositive control over the shares held by it.

(4) Mountain Partners AG directly holds 8,771,880 bearer shares in Bluehill ID. Includes (i) 4,314,718 bearer shares of Bluehill ID and currently exercisable options to acquire 3,914,790 shares bearer shares of Bluehill ID that are held by BH Capital Management AG, of which Mountain Partners AG is a 51% shareholder, and (ii) 2,069,363 bearer shares of Bluehill ID held by Mountain Super Angel AG, as Mountain Partners AG owns 100% of Mountain Super Angel AG s fund manager. Mountain Partners AG disclaims beneficial ownership of the bearer shares in Bluehill ID held or beneficially owned by Mountain Super Angel AG and BH Capital Management AG, except to the extent of its pecuniary interest in BH Capital Management AG.

(5) Includes options to purchase 3,914,790 bearer shares in Bluehill ID pursuant to the Call Option Agreement that are currently exercisable and may be exercised at any time prior to June 30, 2014, at an exercise price of CHF 1.00 per share. BH Capital Management AG is controlled and owned by Ayman S. Ashour and Mountain Partners AG, which is an affiliate of Daniel S. Wenzel and Dr. Cornelius Boersch.

(6) Based on information provided by Lincoln Vale European Partners Master Fund, LP to Bluehill ID. Following the Offer includes 1,545,692 shares of SCM common stock currently held by Lincoln Vale.

(7) Mountain Super Angel AG is a fund managed by Mountain Capital Management AG, of which Mountain Partners AG owns 100%.

(8) Includes 20,561,120 bearer shares in Bluehill ID held or beneficially owned by the following entities: (i) Mountain Partners AG, 8,771,880 shares; (ii) Mountain Super Angel AG, 2,069,363 shares; (iii) Rosenberg Venture AG, 1,490,369 shares; and (iv) BH Capital Management AG, 4,314,718 shares and currently exercisable options to acquire 3,914,790 shares. The directors and officers of Bluehill ID disclaim beneficial ownership of the bearer shares in Bluehill ID held or beneficially owned by Mountain Partners AG, Mountain Super Angel AG, Rosenberg Venture AG and BH Capital Management AG, except to the extent of their pecuniary interest in each such entity.

Table of Contents

MANAGEMENT

SCM s Board of Directors

The Current Board of Directors of SCM

SCM s board of directors is divided into three director classes with staggered three-year terms. Currently, SCM s board consists of seven directors, of which two directors serve in Class I, three directors serve in Class II and two directors serve in Class III. The board of directors has authorized up to eight directors. The following individuals currently serve on SCM s board of directors:

Name	Age	Position
Werner Koepf	67	Chairman of the Board
Steven Humphreys	48	Director
Dr. Hans Liebler	40	Director
Felix Marx	42	Chief Executive Officer and Director
Lawrence W. Midland	67	Executive Vice President and Director
Douglas Morgan	56	Director
Simon Turner	57	Director

Werner Koepf has served as a director of SCM since February 2006 and as Chairman of the board of directors since March 2007. It is expected that Mr. Koepf will resign from SCM s board of directors upon the closing of the Offer. However, his current term expires, and he is standing for re-election, at the 2009 annual meeting of SCM s stockholders which is being held October 29, 2009. Mr. Koepf currently is an advisor to the venture capital firm Invision AG. From 1993 to 2002, Mr. Koepf held a variety of senior management positions with Compaq Computer Corporation GmbH, including Vice President and General Manager of the General Business Group from 1993 to 1999; Vice President and General Manager of Compaq Europe, Middle East and Africa (EMEA) from 1999 to 2000; and Chief Executive Officer and Chairman for Compaq Computer, EMEA from 2000 to 2001. From 1989 to 1993, Mr. Koepf was Chairman and Chief Executive Officer for European Silicon Structures SA, an ASIC manufacturer. Prior to 1993, Mr. Koepf held various senior management positions at Texas Instruments Inc., including Vice President and General Manager of several divisions of the group. Mr. Koepf received a master s degree in business administration from the University of Munich and a bachelor s degree with honors in electrical engineering from the Technical College in St. Poelten, Austria.

Steven Humphreys has served as a director of SCM since July 1996 and as Chairman of the board of directors from April 2000 to March 2007. His current term expires at the 2011 annual meeting of SCM s stockholders. Since October 2008, Mr. Humphreys has served as Chief Executive Officer and President of Kleer Corporation, a maker of wire audio technology. Since March 2008, Mr. Humphreys has served as a director of ActivIdentity Corporation, a provider of digital identity solutions. Since October 2003, he has served as Chairman of Robotic Innovations International, Inc., an acquirer and developer of technologies for broad-based applications of robotics, service automation and automated companion devices. From October 2001 to October 2003, he served as Chairman of the Board and Chief Executive Officer of ActivCard Corporation, a provider of digital identity management software. From July 1996 to October 2001, Mr. Humphreys was an executive officer of SCM, serving as President and Chairman of the Board from July 1996 until December 1996, at which time he became Chief Executive Officer and served as President and Chief Executive Officer until April 2000. Previously, Mr. Humphreys was President of Caere

Corporation, an optical character recognition software and systems company. Prior to Caere, he spent ten years with General Electric Company in a variety of positions. Currently, Mr. Humphreys also serves as a director of HeadThere, Inc., a communications robotics device company, and Ready Solar, Inc., a provider of standardized residential solar systems. He also is a director of several privately held companies, a limited partner and advisor to several venture capital firms and from October 2001 to December 2003 was a director of ActivCard. Additionally, Mr. Humphreys was elected to the school board of the Portola Valley Public School District in 2007, and has served on the board of Summit Preparatory Public Charter High School since 2003. Mr. Humphreys holds a B.S. degree from Yale University and M.S. and M.B.A. degrees from Stanford University.

Dr. Hans Liebler has served as a director of SCM since June 2008. His current term expires at the 2011 annual meeting of SCM s stockholders. Since July 2006, Dr. Liebler has served as a partner of Lincoln Vale European Partners, an investment management company that he co-founded which is focused on strategic long-term investments in European small- and mid-cap companies, and which is currently the largest single stockholder of SCM. Currently, he also serves on the investment committee of Lincoln Vale. From September 2002 to July 2006, Dr. Liebler managed an investment fund he had conceived for Allianz AG, applying a private equity approach to European publicly listed companies. Previous to this, from September 1996 to September 2002, he worked as a management consultant for McKinsey & Company, initially in the company s Madrid and New York offices and subsequently as co-leader of McKinsey s German Corporate Finance practice. From 1993 to 1995, Dr. Liebler was an investment banker for S.G. Warburg in London. Since 1998, Dr. Liebler has also served as an adjunct professor at the European Business School in Germany. He holds a Master s degree in Business Administration from the University of Munich in Germany and a Ph.D in Finance from the University of St. Gallen in Switzerland.

Felix Marx joined SCM as Chief Executive Officer and director in October 2007. His current term as a director of SCM expires at the 2010 annual meeting of SCM s stockholders. Previously, from 2003 to October 2007, Mr. Marx held a variety of management positions with NXP Semiconductors and Philips Semiconductors, both a specialty semiconductor manufacturer for the smart card industry. Most recently, he served as General Manager of NXP s Near Field Communication business and as President of Moversa, a Joint Venture between NXP Semiconductors and Sony Corporation. Prior to this, Mr. Marx served as General Manager of NXP s Contactless & Embedded Security business. From 2002 to 2003, Mr. Marx was a business consultant with Team Training Austria. Prior to this, he worked for several years in the data and voice networking sector, where he held various sales, marketing, product management, business line and general management positions with companies including Global One Telecommunications and Ericsson Telecom AB. He holds a bachelor s degree in engineering from the Technical Academy in Vienna , a postgraduate degree in Business Administration from the University of Commerce in Vienna and a Masters of Advanced Studies in Knowledge Management from Danube University in Austria.

Lawrence W. Midland has served as a director of SCM since May 2009. His current term expires, and he is standing for re-election, at the 2009 annual meeting of SCM s stockholders which is being held October 29, 2009. He was appointed to the board of directors and as an Executive Vice President of SCM and President of SCM s Hirsch subsidiary following the completion of the merger of SCM and Hirsch. Previously, Mr. Midland was President of Hirsch, which he co-founded in August 1981, and for which he served as a director. Mr. Midland became President and Chairman of the board of Hirsch in March 1986 and held those positions continuously until the completion of the merger. Mr. Midland previously served as president of several companies which were all sold profitably, including Retirement Inns of America, Pension Properties Trust, a California REIT, and Pension Administrative Services. Previously Mr. Midland also held various sales positions in investment related activities following his employment as a field engineer with Shell Oil Company. He holds a B.S. degree in Physics (With Distinction) from the University of Oklahoma and an M.B.A. degree from Pepperdine University.

Douglas Morgan has served as a director of SCM since May 2009. His current term expires at the 2010 annual meeting of SCM s stockholders. He was appointed to the board of directors following the completion of the merger of Hirsch and SCM, and had previously served on the board of Hirsch since June 2007. Mr. Morgan is currently CEO and chairman of Performance Strategies, Inc., a consulting company he founded in 1995 specializing in business development, corporate communications, and technology and Internet utilization. His early career included technical and management positions with Computer Sciences Corporation, NCR, and Hewlett Packard. In the early 1980s, he founded Unified Technologies, Inc., which proved instrumental in the launch of Hirsch, helping to locate the company s original financing and subsequently designing Hirsch s original core products. Mr. Morgan subsequently served as Hirsch s Vice President of Engineering and Development for five years, helping define the company s product line and business strategy. Mr. Morgan is a magna cum laude graduate of both MIT, with a Bachelors Degree in Computer Science and Electrical Engineering, and Stanford University, with a Masters Degree in Engineering. He was appointed a National Science Foundation Fellow, has served as an expert witness in intellectual property cases, and is the holder of seven U.S. patents.

Simon Turner has served as a director of SCM since July 2000. His current term expires, and he is standing for re-election, at the 2009 annual meeting of SCM s stockholders which is being held October 29, 2009. Since his retirement from DSG international plc in December 2008, Mr. Turner has provided consultancy services to large retail companies, including PC manufacturer ACER Group. From January 2006 to December 2008, Mr. Turner served as Group Sourcing Director for consumer electronic retailer DSG international plc. From January 2002 to January 2006, Mr. Turner was Managing Director of the PC World Group of DSG, responsible for operations at PC World, PC World Business and Genesis Communications in the UK and PC City in Europe. From February 1999 to January 2002, Mr. Turner was Managing Director of PC World, a large UK reseller of PCs and PC-related equipment. From December 1996 to February 1999, Mr. Turner was Managing Director of Philips Consumer Electronics, UK and Ireland. Prior to that, he also served as Senior Vice President of Philips Media, Commercial Director of Belling and Company and Group Marketing Manager at Philips Consumer Electronics. Mr. Turner is also a non-executive director of Yorkshire Building Society, which is the UK s third largest member-owned savings and loan institution. Mr. Turner holds a B.S. degree from the University of Surrey in the U.K.

To the knowledge of SCM s management, there are no family relationships between any of its current directors and any other of its directors or executive officers.

The Board of Directors of SCM Following the Offer

Following the closing of the Offer, the SCM board of directors is expected to be increased from seven to nine directors, and include three appointees of Bluehill ID Ayman S. Ashour, Dr. Cornelius Boersch and Daniel S. Wenzel who are expected to be appointed to the board as of the closing of the Offer. Werner Koepf, SCM s current Chairman of the Board, is expected to resign upon the closing of the Offer. SCM currently anticipates that the following individuals will serve as its board of directors following closing of the Offer:

Name	Age	Position
Ayman S. Ashour	49	Executive Chairman of the Board
Dr. Cornelius Boersch	41	Director
Steven Humphreys	48	Director
Dr. Hans Liebler	40	Director
Felix Marx	42	Chief Executive Officer and Director
Lawrence W. Midland	67	Executive Vice President and Director
Douglas Morgan	56	Director
Simon Turner	57	Director
Daniel S. Wenzel	32	Director

Ayman S. Ashour is the founder and CEO of Bluehill ID. He has served as President of the board of directors since Bluehill ID s founding in 2007. Mr. Ashour also is the Principal of Newton International Management, a strategy consulting firm focused on the security and identification technology industry. From 2001 to 2005 Mr. Ashour was consultant and later COO and CEO of ASSA ABLOY Identification Technology business where he was responsible for the worldwide development of one of the largest and most successful RFID companies. Mr. Ashour served as Divisional Managing Director Williams Plc in the Asia Pacific region from 1997 to 2000 where he was responsible for Chubb Security, Kidde & Yale brands and managed the global operations of Guardforce International and the Chubb Physical Security Group. From 1990 to 1997 Mr. Ashour was with Williams PLC, where he served as Marketing Director of Kidde Group, Vice President of Kidde-Fenwal, Inc and as President of Kidde Fire Fighting, Inc. Mr. Ashour holds a bachelor s degree in Electronic and Electrical Engineering from the University of Manchester in the U.K. He is currently an Adjunct Lecturer for the MBA program at the Sawyer Business School at Suffolk University in Boston. Mr. Ashour is currently a member of the board of directors of the following companies: ACiG AG, Advanced Digital Security Solutions Inc., Arygon Technologies AG, Bluehill ID, Inc., and BH Capital

Management AG. In addition, Mr. Ashour is currently a partner in the following private companies, each based in Newton, Massachusetts: Newton International Management, LLC., Trade-3, LLC., tSecu LLC as well as Verifier Security, based in Florida.

Dr. Cornelius Boersch is a director of Bluehill ID and has been an entrepreneur since 1991 when he founded Sabeco GmbH. He served as CEO of ACG AG which he founded in 1995 and was responsible for the IPO of the company in 1999 (NEMAX50). During this time, he acquired and founded more than 25 companies worldwide. In

2000 he was elected entrepreneur of the year in Germany. ACG was sold in 2003 to ASSA ABLOY AB. Dr. Boersch is considered to be one of the most acknowledged business angels and fund investors in the German speaking region. Since 2005, Dr. Boersch has combined his entrepreneurial activities in Mountain Partners AG (Switzerland), where he is on the board of directors. Dr. Boersch holds a degree in Business Administration from the European Business School and a Ph.D. from the University of Essen in Germany.

Daniel S. Wenzel is a founding partner of Bluehill ID and of Mountain Partners AG. He is responsible for the strategic direction and expansion of Mountain Partners AG. Prior to founding Mountain Partners AG in 2005, Mr. Wenzel was the Chief of Staff of the board of management of ACG AG and responsible for all strategic projects, merger and acquisition transactions and financing from 2001 to 2005. During this time he successfully achieved the spin-off and the sale of the most important division of the technology group. His career has been complemented by prior experience with Dresdner Bank Latin America in 1998, BNP Paribas in 1999 and Bain & Company in 2000. Mr. Wenzel completed his studies at the WHU, Otto Beisheim Graduate School of Business Management, the Helsinki School of Economics, Finland and the Universidad Adolfo Ibañez, Chile, where he obtained his master degree (Diplom-Kaufmann) in business administration. Mr. Wenzel serves on the board of a number of Mountain Partners portfolio companies based in Germany or Switzerland.

To the knowledge of SCM s management, there are no family relationships between Messrs. Ashour or Wenzel, or Dr. Boersch and any of SCM s directors or executive officers.

Independence of SCM s Current Board of Directors

SCM s board of directors has reviewed the independence of each of its directors and considered whether any director has had a material relationship with the company or its management that could compromise his ability to exercise independent judgment in carrying out his duties and responsibilities. As a result of this review, SCM s board of directors affirmatively determined that Mr. Koepf, Mr. Humphreys, Dr. Hans Liebler, Mr. Douglas Morgan, and Mr. Turner (collectively, the non-employee directors) are independent under the corporate governance standards of the Marketplace Rules of the NASDAQ Stock Market and Rule 10A-3 of the Securities Exchange Act of 1934.

In connection with the determination of independence of Dr. Hans Liebler, the board of directors considered Dr. Liebler s relationship with SCM s largest stockholder, Lincoln Vale European Partners, of which Dr. Liebler is a founder and member of the investment committee. The board of directors determined that such relationship would not compromise Dr. Liebler s ability to exercise independent judgment in carrying out his duties and responsibilities. In agreeing to serve as a member of SCM s board of directors, Dr. Liebler must act independently of Lincoln Vale European Partners in discharging his fiduciary duties to stockholders of the company and also is obligated not to disclose to Lincoln Vale European Partners or use for his own benefit any confidential information that he may obtain during his service on the board. Dr. Liebler disclaims shared voting or dispositive power over any securities held by the fund.

Compensation of SCM Directors

Annual Cash Compensation

During 2008, SCM s non-employee directors were paid in the currency of the country of their residence, using a fixed exchange rate of 0.93 per U.S. dollar for SCM s German-based directors and £0.63 per U.S. dollar for SCM s UK-based director. During 2008, each non-employee member of SCM s board of directors was eligible to receive the following cash compensation:

an annual retainer of $10,000 for each member of the board of directors, except for the Chairman, who is eligible to receive an annual retainer of $20,000;

additional annual retainer of $5,000 for service on the Audit Committee of the board of directors, except for the Chairman, who is eligible to receive an annual retainer of $10,000;

additional annual retainer of $2,000 for service on the Compensation or Nominating Committees of the board of directors, except for the Chairman of such committees, who are each eligible to receive an annual retainer of $4,000; and

meeting fees of $1,000 for physical attendance at each board of directors meeting.

Additionally, SCM reimburses its non-employee directors for all reasonable out-of pocket expenses incurred in the performance of their duties as directors, which in practice primarily consist of travel expenses associated with board or committee meetings or with committee assignments.

Change in Cash Compensation for 2009

During 2008, the Compensation Committee conducted a review of compensation paid to SCM board members that included comparisons of cash and equity compensation made to directors at six other security companies, including ActivIdentity, Entrust, L-1 Identity Solutions, Secure Computing (subsequently acquired by McAfee), Tumbleweed Communication (subsequently acquired by Axway Inc.) and Vasco Data Security. Based on this review, in December 2008, the Compensation Committee approved an increase in the cash compensation paid to SCM s non-employee directors, effective beginning in 2009. Annual cash compensation was increased from $10,000 to $20,000 for all directors except for the Chairman of the Board, whose annual cash compensation was increased from $20,000 to $40,000. Additionally, directors will also receive a fee of $500 for attendance at each telephonic board of directors meeting lasting more than 60 minutes, whereas previously no fees had been paid for attendance at telephonic board of directors meetings. Additionally, members of SCM s board of directors who serve on the Strategic Advisory Committee, which was created in June 2009, are eligible to receive cash compensation of $2,000 per year, except for the Chairman, who is eligible to receive annual cash compensation of $4,000. All other components of cash compensation remain unchanged for 2009.

Equity Compensation

During 2008, each non-employee member of SCM s board of directors was eligible to receive option awards under the terms of the SCM 2007 Stock Option Plan. Under this plan, new members of the board of directors receive an initial option grant to purchase 10,000 shares of the SCM common stock. Continuing members of the board of directors who have served for at least six months receive an annual option grant to purchase 5,000 shares of SCM common stock, awarded on the date of SCM s Annual Meeting of Stockholders. Both of these option grants vest 1/12th per month over the one-year period following the date of grant.

During 2008, each of SCM s non-employee directors, with the exception of Dr. Liebler, received an annual grant of 5,000 options for shares of SCM common stock. All such annual grants were made on July 1, 2008, the date of SCM s Annual Meeting, at an exercise price of $2.91 per share, which was the NASDAQ closing price on that day.
Dr. Liebler received an initial option grant to purchase 10,000 shares of SCM common stock upon joining the board of directors. His grant was made on June 2, 2008 at an exercise price of $2.95, which was the NASDAQ closing price on that day.

Director Compensation for Fiscal Year 2008

The following Director Compensation Table sets forth summary information concerning the compensation paid to SCM s non-employee directors in 2008 for services to the company.

Name	Fees Earned or Paid in Cash	Option Awards (1)	Total ($)
Werner Koepf Chairman(2)	$ 31,000	$ 10,344	$ 41,344
Steven Humphreys Former Chairman(3)	$ 22,000	$ 10,344	$ 32,344
Dr. Hagen Hultzsch(4)	$ 24,000	$ 10,344	$ 34,344
Dr. Hans Liebler(5)	$ 10,500	$ 7,564	$ 18,064
Simon Turner(6)	$ 29,000	$ 10,344	$ 39,344

(1) The amounts in this column represent the U.S. dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with SFAS 123(R). These amounts may reflect options

granted in years prior to 2008. The grant date fair value of these annual stock options awarded to each director in 2008, other than Mr. Liebler, is approximately $6,751. The grant date fair value of the initial stock options awarded to Dr. Liebler is approximately $13,154. The grant date fair value of the options awards is calculated using the Black-Scholes-Merton valuation model using the following assumptions: a dividend rate of zero, an interest rate for the expected life of the option at the date of grant, an expected option life of 4.00 years, and volatility based on historical averages at the date of grant. See Note 2 to the Consolidated Financial Statements for the period ended December 31, 2008 for more information about how SCM accounts for stock-based compensation.

(2) Mr. Koepf received a fee of $20,000 for his service as Chairman of the board of directors in 2008. He also received a fee of $2,000 for his service as a member of the Compensation Committee and a fee of $4,000 for his service as Chairman of the Nominating Committee during 2008. Additionally, he received a fee of $1,000 for each physical board meeting attended, amounting to $5,000. Mr. Koepf had 25,000 options outstanding as of December 31, 2008, of which 22,083 were exercisable.

(3) Mr. Humphreys received a fee of $10,000 for his service as a director in 2008. He also received a fee of $5,000 for his service as a member of the Audit Committee and a fee of $2,000 for his service as a member of the Nominating Committee during 2008. Additionally, he received a fee of $1,000 for each physical board meeting attended, amounting to $5,000. Mr. Humphreys had 66,415 options outstanding as of December 31, 2008, of which 63,498 were exercisable.

(4) Dr. Hultzsch received a fee of $10,000 for his service as a director in 2008. He also received $5,000 for his service as a member of the Audit Committee and a fee of $4,000 for his service as Chairman of the Compensation Committee during 2008. Additionally, he received a fee of $1,000 for each physical board meeting attended, amounting to $5,000. Dr. Hultzsch had 40,000 options outstanding as of December 31, 2008, of which 37,083 were exercisable. Dr. Hultzsch resigned from SCM s board of directors in April 2009.

(5) Dr. Liebler joined the board of directors of SCM effective June 1, 2008, and received a prorated fee of $5,833 for his service as a director from June through December 2008. He also received a prorated fee of $834 for his service as a member of the Compensation Committee and $833 for his service as a member of the Nominating Committee from July through December 2008. Additionally, he received a fee of $1,000 for each physical board meeting attended, amounting to $3,000. Dr. Liebler had 10,000 options outstanding as of December 31, 2008, of which 5,000 were exercisable.

(6) Mr. Turner received a fee of $10,000 for his service as a director in 2008. He also received $10,000 for his service as Chairman of the Audit Committee, $2,000 for his service as a member of the Compensation Committee and $2,000 for his service as a member of the Nominating Committee during 2008. Additionally, he received a fee of $1,000 for each physical board meeting attended, amounting to $5,000. Mr. Turner had 50,000 options outstanding as of December 31, 2008, of which 47,083 were exercisable.

The Board of Directors and Management of Bluehill ID Following the Offer

The Board of Directors of Bluehill ID

Following the closing of the Offer, Bluehill ID will use commercially reasonable efforts to have appointed, upon request, two members of SCM s board of directors, including its Chief Executive Officer, Felix Marx, to its board of directors (*Verwaltungsrat*). Following the closing of the Offer, it is expected that Bluehill ID s board of directors will consist of between four and six directors.

Current Executive Officers of Bluehill ID

Immediately after the closing of the Offer, Bluehill ID s officers are expected to remain substantially as they existed prior to the closing of the Offer. Bluehill ID has employment agreements with two of its executive officers: Ayman S. Ashour, and Melvin Denton-Thompson.

Bluehill ID Employment Agreement with Ayman S. Ashour

Bluehill ID entered into a consulting agreement, dated August 21, 2009, with Newton International Management LLC to secure the services of Mr. Ashour as Bluehill ID s Chief Executive Officer and President of the

Board of Directors. The agreement is effective for a three-year term, commencing August 1, 2009, and may be renewed on terms acceptable to both parties for an additional three years. Bluehill ID is required to provide notice of at least one year of its intent to renew. The agreement may be terminated by Bluehill ID at anytime with cause, or by providing twelve months prior written notice if such termination is without cause. If the consulting agreement, and therefore Mr. Ashour, is terminated without cause, Newton International Management, and thereby Mr. Ashour, is entitled to receive (i) the base monthly compensation until the earlier to expire of 24 months from the date of termination or the then current term of the agreement and (ii) bonus payments and benefits until the expiry of the current term.

Under the agreement, Mr. Ashour, through Newton International Management, is entitled to annual compensation (the Fees) in the amount of CHF 300,000 (approximately $290,827), payable in monthly installments. Mr. Ashour, through Newton International Management, is also entitled to an annual bonus (the Base Bonus) of up to CHF 300,000 (approximately $290,827), based upon Bluehill ID s financial performance and other criteria, payable 50% in cash and 50% in bearer shares in Bluehill ID, which stock will be valued at the time of issuance and subject to a 36-month lock-up period from the date of issuance. The exact amount of the Base Bonus is subject to determination by the compensation committee of Bluehill ID s board of directors. Mr. Ashour, through Newton International Management, is entitled to receive an additional bonus subject to achievement of certain financial goals and share price targets (the Peak Bonus) determined by the compensation committee of Bluehill ID s board of directors, payable in 36-month options which vest 12 months after issuance, with such options granted under the Bluehill ID Option Plans. The number of shares subject to the option is equal to the total amount received by Mr. Ashour, through Newton International Management, in Fees and Base Bonus, calculated in Euros, divided by the price per share at the time of issuance.

Mr. Ashour is entitled to health, pension and other customary benefit plans provided by Bluehill ID and available to all Bluehill ID Employees, as well as five weeks of annual vacation. In addition, he receives a monthly car and housing allowance of CHF 1,500 to cover expenses in Switzerland. The agreement is subject to certain other terms and provision and includes a confidentiality and non-disclosure undertaking, which expires three years after expiration of the term.

Following the closing of the Offer, Bluehill ID, SCM and Mr. Ashour intend to review the terms of the consulting agreement to determine whether any changes are necessary in light of the business combination and Mr. Ashour s role as Executive Chairman of SCM, including the possibility of entering into an agreement directly with Mr. Ashour.

Bluehill ID Employment Agreement with Melvin Denton-Thompson

Bluehill ID, through its wholly-owned subsidiary Bluehill Micro Tech GmbH, entered into an agreement, dated April 29, 2008, with Missions-Cadres SARL to secure the services Mr. Denton-Thompson as Bluehill ID s Chief Operating Officer and Chief Financial Officer. The agreement is effective for a three-year term, commencing May 1, 2008, and is renewable at the option of Bluehill ID for an additional 36 months. The agreement may be terminated by either party with or without cause upon six months notice.

Under the agreement, Mr. Denton-Thompson, through Missions-Cadres SARL, is entitled to an annual base salary of 150,000 (approximately $220,805) in cash, payable in monthly installments, and 50,000 (approximately $73,602) in bearer shares in Bluehill ID, which stock will be valued at the time of issuance and subject to a 12-month lockup period from the date of issuance. Mr. Denton-Thompson, through Missions-Cadres SARL, is also entitled to an annual base bonus of up to 100% of the base cash salary amount (Base Bonus), based upon Bluehill ID s financial performance in Europe, payable 50% in cash and 50% in bearer shares in Bluehill ID, which stock will be valued at the time of issuance and subject to a 36-month lockup period from the date of issuance. The exact amount of the Base Bonus is subject to determination by the compensation committee of Bluehill ID s board of directors.

Mr. Denton-Thompson, through Missions-Cadres SARL, is also entitled to receive an additional bonus (Peak Bonus) subject to Bluehill ID s achievement of certain financial goals and share price targets determined by the compensation committee of Bluehill ID s board of directors, payable in 36-month options, vesting 12 months after issuance, with such options granted under the Bluehill ID Option Plans. The number of shares subject to the option is equal to the total amount of received by Mr. Denton-Thompson, through Missions-Cadres SARL, in cash salary and annual base bonus, calculated in Euros, divided by the price per share at the time of issuance.

Mr. Denton-Thompson is entitled to costs relating to social, pension and health insurance in France or elsewhere, as well as five weeks of annual vacation.

The agreement is subject to certain other terms and provision and includes a confidentiality and non-disclosure undertaking, which expires three years after expiration of the term. Following the closing of the Offer, Bluehill ID, SCM and Mr. Denton-Thompson intend to review the terms of Mr. Denton-Thompson s agreement to determine whether any changes are necessary in light of the business combination and the role of Mr. Denton-Thompson with the combined companies, including the possibility of entering into an agreement directly with Mr. Denton-Thompson.

Current Executive Officers of SCM

Information concerning SCM s current executive officers, including their backgrounds and ages as of December 31, 2008, is set forth below. All SCM executive officers hold their positions for an indefinite term and serve at the pleasure of SCM s board of directors.

On September 30, 2009 Stephan Rohaly, SCM s Vice President Finance, Chief Financial Officer and Secretary resigned. Martin Wimmer was appointed by SCM s Board of Directors to serve as interim Chief Financial Officer, in addition to retaining his current position of Vice President Corporate Finance, until SCM s Board of Directors names a new Chief Financial Officer. It is currently anticipated that a new Chief Financial Officer will be appointed before the end of fiscal year 2009.

To the knowledge of SCM s management, there are no family relationships between any of SCM s current executive officers and any of its current directors or other executive officers.

Felix Marx, 42
Chief Executive Officer and Director

Felix Marx has served as Chief Executive Officer and as a director of the company since October 2007. Previously, from 2003 to October 2007, Mr. Marx held a variety of management positions with NXP Semiconductors and Philips Semiconductors, both a specialty semiconductor manufacturer for the smart card industry. Most recently, he served as General Manager of NXP s Near Field Communication business and as President of Moversa, a Joint Venture between NXP Semiconductors and Sony Corporation. Prior to this, Mr. Marx served as General Manager of NXP s Contactless & Embedded Security business. From 2002 to 2003, Mr. Marx was a business consultant with Team Training Austria. Prior to this, he worked for several years in the data and voice networking sector, where he held various sales, marketing, product management, business line and general management positions with companies including Global One Telecommunications and Ericsson Telecom AB. He holds a bachelor s degree in engineering from the Technical Academy in Vienna , a postgraduate degree in Business Administration from the University of Commerce in Vienna and a Masters of Advanced Studies in Knowledge Management from Danube University in Austria.

Martin Wimmer, 40
Interim Chief Financial Officer, Vice

Martin Wimmer joined SCM in June 2005 as its Finance Director Europe and was promoted to Vice President Corporate Finance in January 2009.

President Corporate Finance	Mr. Wimmer was appointed by SCM s board of directors to serve as interim Chief Financial Officer on September 23, 2009, with such appointment effective September 30, 2009. Prior to joining SCM, Mr. Wimmer served as European Financial Controller of Hurco Companies Inc., an industrial automation company, and previously headed Finance for the German operations of Take-Two Interactive Software Inc.

Lawrence W. Midland, 67
Executive Vice President, President of Hirsch business division, and Director

Lawrence W. Midland has served as a director of SCM since May 2009. He was appointed to the board of directors and as an Executive Vice President of SCM and President of SCM s Hirsch subsidiary following the completion of the merger of SCM and Hirsch. Previously, Mr. Midland was President of Hirsch, which he co-founded in August 1981, and for which he served as a director. Mr. Midland became President and Chairman of the board of Hirsch in March 1986 and held those positions continuously until the completion of the merger. Mr. Midland previously served as president of several companies which were all sold profitably, including Retirement Inns of America, Pension Properties Trust, a California REIT, and Pension Administrative Services. Previously Mr. Midland also held various sales positions in investment related activities following his employment as a field engineer with Shell Oil Company. He holds a B.S. degree in Physics (With Distinction) from the University of Oklahoma and an M.B.A. degree from Pepperdine University.

Dr. Manfred Mueller, 39
Executive Vice President, Strategic Sales and Business Development

Dr. Manfred Mueller has served as Executive Vice President, Strategic Sales and Business Development since March 2008. He joined SCM Microsystems in August 2000 as Director of Strategic Business Development. From July 2002 to July 2005, he served as Director of Strategic Marketing. He was appointed Vice President of Strategic Business Development in July 2005. He served as Vice President Marketing from February 2006 to April 2007, at which time he was named Vice President Sales, EMEA. Prior to SCM, from August 1998 to July 2000, Dr. Mueller was Product Manager and Business Development Manager at BetaResearch GmbH, the digital TV technology development division of the Kirch Group. Dr. Mueller holds masters and Ph.D degrees in Chemistry from Regensburg University in Germany and an MBA from the Edinburgh Business School of Heriot Watt University in Edinburgh, Scotland.

SCM Compensation Discussion and Analysis

General Philosophy/Objectives

The primary goals of SCM s compensation program, including its executive compensation program, are to attract and retain employees whose abilities are critical to SCM s long-term success and to motivate employees to achieve superior performance.

To achieve these goals, SCM attempts to:

offer compensation packages that are competitive regionally and that provide a strong base of salary and benefits;

maintain a portion of total compensation at risk, particularly in the case of SCM s executive officers, with payment of that portion tied to achievement of specific financial, organizational or other performance goals; and reward superior performance.

SCM s compensation program includes salary, performance-based quarterly and annual bonuses, long-term incentive compensation in the form of stock options and various benefits and perquisites.

Role of the Compensation Committee

SCM s Compensation Committee oversees all aspects of executive compensation. The Compensation Committee plays a critical role in establishing SCM s compensation philosophy and in setting and amending elements of the compensation package offered to SCM s Named Executive Officers. In 2008, SCM s Named Executive Officers included Felix Marx, Chief Executive Officer; Stephan Rohaly, Chief Financial Officer; Eang Sour Chhor, Executive Vice President, Strategy, Marketing and Engineering; and Manfred Mueller, Executive Vice President, Strategic Sales and Business Development. Mr. Rohaly resigned from SCM effective September 30, 2009, and Mr. Chhor resigned from SCM effective June 2009. Lawrence Midland joined SCM in May 2009 as Executive Vice President and President of SCM s Hirsch subsidiary, and Martin Wimmer was appointed to serve as interim Chief Financial Officer, effective September 30, 2009, in addition to continuing in his role as Vice President Corporate Finance.

On an annual basis, or as required in the case of promoting or hiring an executive officer, the Compensation Committee determines the compensation package to be provided to SCM s Chief Executive Officer, SCM s other executive officers and SCM s directors. On an annual basis, the Compensation Committee undertakes a review of the base salary, bonus targets and equity awards of each of SCM s Named Executive Officers. This review entails an evaluation of their respective compensation based on the Compensation Committee s overall evaluation of their performance toward the achievement of SCM s financial, strategic and other goals, with consideration given to comparative executive compensation data, primarily from a small group of companies of similar size and within a similar segment of the security industry to SCM (as described in more detail below). Based on its review, from time to time the Compensation Committee has increased the salary, potential bonus amounts and/or equity awards for SCM s executive officers, based upon the performance of the executive officer, a change in scope of an executive officer s responsibilities and/or as a competitive practice based on a review of compensation at companies that are similar to SCM.

Overview of Compensation Program

SCM was originally formed in Germany in 1990 and has continued to have an active presence in Germany and throughout Europe in its target product markets. Since its initial public offering in October 1997, SCM common stock has been dually traded on the NASDAQ Stock Market and the Frankfurt Stock Exchange, previously on the Neuer Market and now on the regulated market (Prime Standard). As a result, although SCM is a small company, it has maintained a relatively high level of visibility in the European marketplace and German financial markets. This influences SCM s executive compensation program.

SCM does not employ an overall model or policy to allocate among the compensation elements it utilizes. In general, SCM employs cash bonuses to motivate and reward its executive officers for the achievement of annual and quarterly or other short-term performance objectives and SCM employs annual grants of stock options that vest over time to motivate and reward contributions to SCM s performance over the longer term. From time to time, however, SCM also utilizes stock options with shorter vesting periods to provide additional incentives for the achievement of short-term objectives that are seen as critical to its success.

SCM believes that its compensation practices, as described below, allow it to achieve an appropriate balance of compensation elements for its executive officers that support its overall compensation program goals.

Compensation Elements

Base Salary. Base salary provides fixed compensation based on competitive market practice and is intended to acknowledge and reward core competence in the executive role relative to skills, experience and contributions to SCM. Base salaries for executives are reviewed annually, and more frequently when there are any changes in responsibilities.

The Compensation Committee reviewed base salary levels for Mr. Marx, Mr. Rohaly and Dr. Mueller at the beginning of 2008 as part of its annual review of executive compensation. The committee did not review the salary of Mr. Chhor, as his compensation had recently been set prior to his joining SCM in February 2008. In conducting their reviews, the Compensation Committee (1) gave consideration to each officer s salary history with previous employers; (2) considered informal data on salaries of executive officers in similar positions based on general comparative data for the technology industry from the Economic Research Institute and Salary.com, although SCM did not benchmark with respect to comparative data; (3) reviewed specific salary data for the chief executive officers and chief financial officers at two companies the Compensation Committee considered to be most comparable in size and industry focus to the company, Vasco Data Security and ActivIdentity, although SCM did not benchmark with respect to comparative data; (4) relied on the professional experience of the Compensation Committee and Board members related to compensation practices in Europe; (5) considered the recommendations of Mr. Marx in the case of Mr. Rohaly and Dr. Mueller, based primarily on their respective performance reviews; (6) considered the scope of responsibility, prior experience and past performance of each officer; and (7) considered the specific needs of SCM at the time and in the foreseeable future.

Based on its evaluation, in February 2008 the Compensation Committee approved one-time incentive stock option grants for Mr. Marx and Mr. Rohaly in lieu of annual salary increases, in order to bring equity compensation for these principal officers into alignment with peer companies, including ActivIdentity and Vasco Data Security, and to better align the interests of these executives with those of SCM s stockholders. The Compensation Committee also approved the promotion of Dr. Mueller from Vice President Sales, EMEA to Executive Vice President, Strategic Sales and Business Development, and approved an increase in his annual base salary from 150,000 to 168,000 in light of his anticipated responsibilities for 2008. The new salary level for Dr. Mueller was effective as of April 1, 2008.

In December 2008, the Compensation Committee reviewed the base salary level of Mr. Marx and approved an increase in his annual base salary from 240,000 to 280,000, effective November 1, 2008. The increase was made based on Mr. Marx s performance against objectives set by the Compensation Committee related to establishing a strategic plan for SCM and putting in place programs and resources to achieve growth. These objectives were to create and execute a plan for SCM to enter the contactless smart card reader market with new products and programs and to identify and negotiate with appropriate merger and acquisition candidates to accelerate SCM s revenue generation and increase its operating scale.

Incentive Cash Bonuses. Incentive cash bonuses are intended to motivate and reward executives for their contributions towards achieving corporate performance targets as well as specific corporate objectives that support SCM s short-term goals. During 2008, SCM s primary goal was operating profitability, with a focus both on revenue generation and on cost and expense containment. Therefore, incentive bonuses in 2008 were designed to reward corporate operational performance alone.

On February 6, 2008, the Board of Directors approved an Executive Bonus Plan for 2008 (the 2008 Plan) as recommended by the Compensation Committee. The 2008 Plan was effective as of January 1, 2008 and was unchanged from the previous year. Payments under the 2008 Plan were based both on the achievement of quarterly and annual operating profit goals by SCM. Under the Plan, operating profit is defined as gross margin, less research and development, sales and marketing, and general and administrative expenses, as well as various expenses determined by SCM to be extraordinary. No such extraordinary expenses were excluded from the calculation of operating profit in 2008.

Executive officers eligible to participate in the 2008 Plan with respect to both the quarterly and annual bonus components were Mr. Marx, Mr. Rohaly and Mr. Chhor. As part of his employment agreement signed in January 2008, Mr. Chhor was guaranteed a quarterly bonus payment amounting to 10% of his annual base salary for the first quarter of 2008, prorated for his February 1, 2008 start date.

Because of his sales role, Dr. Mueller was eligible to participate in the annual component of the 2008 Plan only, and was eligible to receive quarterly bonus payments under SCM s Sales Commission Plan, which is described under

Incentive Cash Payouts under the Sales Commission Plan below.

Quarterly Component. Under the quarterly bonus component of the 2008 Plan, executive officers of SCM were eligible to receive quarterly cash bonuses amounting to 10% of their respective annual base salaries, if SCM achieved positive operating profit for that quarterly period. The maximum amount that any executive officer could earn in quarterly bonus payments in the fiscal year was 40% of his respective annual base salary.

Annual Component. Under the annual bonus component of the 2008 Plan, executive officers were eligible to receive additional variable bonuses amounting to between 20% and 40% of their respective annual base salaries, based upon the achievement by SCM of the following annual operating profit targets:

20% of annual base salary would be paid if SCM recorded at least $1.0 million of annual operating profit;

30% of annual base salary would be paid if SCM recorded at least $1.5 million of annual operating profit; and

40% of annual base salary would be paid if SCM recorded at least $2.0 million of annual operating profit.

The maximum amount that any executive officer could earn in combined quarterly and annual bonus payments under the 2008 Plan in the fiscal year was 80% of his respective annual base salary.

Incentive Cash Payouts under the 2008 Plan. SCM did not achieve positive operating profit in any of the four quarterly periods of 2008, and no cash bonuses were awarded under the 2008 Plan for these periods. SCM did not achieve positive operating profit for the full year 2008, and no cash bonuses were awarded under the annual component of the 2008 Plan. As noted above, Mr. Chhor was paid a guaranteed bonus amounting to 10% of his annual base salary for the first quarter of 2008, prorated for his February 1, 2008 start date, as specified in his employment agreement.

Incentive Cash Payouts under the Sales Commission Plan. As noted above, during 2008 Dr. Mueller was eligible to receive quarterly cash awards under SCM s Sales Commission Plan. Under this plan, for each of the four quarters of 2008, Dr. Mueller was eligible to receive a quarterly bonus payment of up to 10% of his then-current annual base salary based on 100% achievement of quarterly revenue goals and individual objectives. Two-thirds of this potential bonus amount was based on the achievement of at least 75% of quarterly revenue targets set forth in SCM s budget and sales forecasts as approved by the Board for each year, and one-third was based upon the achievement of personal quarterly objectives as approved by the Compensation Committee for each quarter. Additionally, if revenue targets were achieved above the 100% level in any quarter, then Dr. Mueller s potential bonus for that quarter would be increased by an additional 2.5% for every percentage point achieved above 100%. At 100% achievement of quarterly revenue targets, Dr. Mueller s target quarterly bonus was 10,000 for revenue generation and 5,000 for individual objectives for the first quarter of 2008, and 11,200 for revenue generation and 5,600 for individual objectives for the second, third and fourth quarters of 2008.

The revenue target for Dr. Mueller in the first quarter of 2008 was $2.7 million. Individual objectives for Dr. Mueller in the first quarter of 2008 included meeting with key strategic partner targets; setting up sales and marketing programs and engaging new distributors in new geographic regions; and setting up a framework to market and sell new USB token products, including creating a business plan, cultivating strategic partners, developing a sales channel and developing marketing collateral. For the first quarter of 2008, Dr. Mueller achieved 88% of his revenue target, resulting in a payout of 70.8% under the revenue portion of the plan, and he achieved 100% of his personal objectives. This resulted in an aggregate payout equal to 80.5% of his target award, or 12,082.

The revenue target for Dr. Mueller in the second quarter of 2008 was $3.1 million. Individual objectives for Dr. Mueller in the second quarter of 2008 included managing strategic partner relationships to support the development of a new USB token business; continue to develop and manage the distribution channel for SCM s eHealth terminals, including the creation and monitoring of pilot deployments; and manage strategic partner relationships aimed at the e-passport market. For the second quarter of 2008, Dr. Mueller achieved 90% of his revenue target, resulting in a payout of 75.1% under the revenue portion of the plan, and he achieved 100% of his personal objectives. This resulted in an aggregate payout equal to 83.4% of his target award, or 14,013.

The revenue target for Dr. Mueller in the third quarter of 2008 was $3.1 million. Individual objectives for Dr. Mueller in the third quarter of 2008 included managing strategic partner relationships to support the development of a new USB token business and securing volume orders for the USB products; finalizing a global marketing strategy for SCM s CHIPDRIVE products; and transferring all EMEA sales activities to a newly hired regional sales executive. For the third quarter of 2008, Dr. Mueller achieved 69% of his revenue target, resulting in a payout of 0% under the revenue portion of the plan, and he achieved 85% of his personal objectives. This resulted in an aggregate payout equal to 28.3% of his target award, or 4,760.

The revenue target for Dr. Mueller in the fourth quarter of 2008 was $11.0 million. Individual objectives for Dr. Mueller in the fourth quarter of 2008 included managing the USB token business and securing volume orders for the USB products; finalizing the business plan for 2009; expanding the global distribution channel as part of SCM s strategy to expand sales into new geographic regions; and planning the 2009 launch of the CHIPDRIVE product line into the U.S. For the fourth quarter of 2008, Dr. Mueller achieved 82% of his revenue target, resulting in a payout of 54% under the revenue portion of the plan, and he achieved 74% of his personal objectives. This resulted in an aggregate payout equal to 61% of his target award, or 10,177.

Additional Performance Cash Bonuses. In December 2008, the Compensation Committee approved the payment of a cash bonus of $333,333 to Mr. Marx to be paid out in March 2009, in recognition of his significant contributions to SCM and his performance in 2008, including his efforts to re-position SCM and to implement its growth strategy, and was contingent upon Mr. Marx s continuing employment with SCM at the time of such payment.

Long-Term Equity Incentives. SCM s stock option program is designed to attract, retain and reward talented employees and executives through long-term compensation that is directly linked to long-term performance. A significant number of SCM s employees are in Germany and India, where stock options are not commonly awarded to non-executive employees, and SCM regards stock options as a competitive tool in its overall compensation program.

SCM grants equity incentives in the form of stock options to each of its executive officers, at the time of hiring, on an annual basis and from time to time as an incentive to achieve specific performance objectives. The exercise price of all options awarded is the closing price of SCM s stock on the NASDAQ Stock Market on the date of grant. SCM believes stock options are an effective way to align executives interests with the interests of SCM s stockholders because the stock options have value only to the extent that the price of SCM s stock increases after the date of grant.

The number of stock options granted to newly hired executive officers is determined by the Compensation Committee, based on SCM s historical practices and on the executive s position. Initial options vest 1/4th after one year and then 1/48th per month for the next three years, such that they are fully vested after four years. Annual top-up grants are made based on the positive results of annual performance reviews and are generally in an amount ranging between 25% and 33% of the options received in the executive officer s initial grant. Annual top-up grants are made based on the positive results of annual performance reviews and are generally in an amount ranging between 25% and 33% of the options received in the executive officer s initial grant. Annual top-up grants vest at a rate of 1/48th per month over four years, commencing at the date of grant. If the executive officer terminates employment before the end of the vesting period, all unvested options are forfeited. As options are granted annually, some portion of an executive officer s options vest each year, rewarding the executive for past service, while an often greater portion remains unvested, creating a long-term incentive to remain with SCM.

In February 2008, the Compensation Committee awarded Mr. Chhor an initial stock option grant of 40,000 shares of SCM common stock upon his joining SCM. At the time, the Compensation Committee also awarded special one-time incentive option grants to Mr. Marx and Mr. Rohaly. These awards were made in lieu of annual salary increases, to increase the long-term incentive portion of their overall compensation package in relation to salary, and to bring equity compensation for these officers into alignment with peer companies. In making its determination, the Compensation Committee reviewed salary and equity data for the chief executive officer and chief financial officer at six companies that operate in similar segments of the security industry to SCM, and which the committee believes are comparable for the purposes of compensation comparison. These companies included ActivIdentity, Entrust, L-1 Identity Solutions, Secure Computing (subsequently acquired by McAfee), Tumbleweed Communications (subsequently acquired by Axway Inc.) and Vasco Data Security.

In April 2008, the Compensation Committee awarded annual top-up grants to Mr. Marx and Mr. Rohaly of 19,800 shares and top-up and promotion grants of 6,500 and 14,000 shares, respectively, to Dr. Mueller. The

Compensation Committee determined the amount to be granted to each executive officer based on his individual performance in past recent periods and in order to retain and motivate each executive in the future.

Benefits and Perquisites. Because SCM has a strong regional presence in Germany, SCM follows the standard European practice of providing either a company car or a car allowance to its executive officers in Germany. SCM leases BMW cars or provide a comparable allowance for its executive officers.

Retirement Payments. On behalf of its executive officers in Germany, SCM makes payments to a government-managed pension program, to government-managed or private health insurance programs, and in some cases for unemployment insurance, as mandated under German employment law.

Severance Benefits

SCM does not have a policy regarding severance or change of control agreements for its executive officers and historically has not offered severance as part of its employment contracts. Under standard employment practice in Germany, notice of termination is required to be given by either the employer or the employee, and the employer is required to continue to compensate the employee for salary and eligible bonus amounts during this period. The length of the notice period varies from company to company. SCM s policy for executive officers generally is to require a notice period of three to six months, following a trial period of initial employment of three to six months. The length of individual notice and trial periods for each executive officer is stated in his employment contract. In lieu of continuing the employment relationship for six months, SCM s employment agreements provide that it can cash out the employee who has given notice. Alternatively, SCM can require that the employee continue to work his or her six month notice period. This practice is included in the majority of SCM s employment agreements with its executive officers. Additionally, under German labor practices, terminated employees also are eligible to continue to receive health and unemployment insurance coverage, pension contributions, car leasing expenses or car allowance, or other benefits provided during their employment, for the duration of the notice period. Further, under German labor practices, terminated employees may also be entitled to receive quarterly or annual bonus payments, the amount of which would be determined based on a variety of factors, including the employee s length of service and perceived contributions to past or future company performance, as well as other factors. Actual bonus payments for which individual employees may become eligible are determined at or following termination, and cannot be projected.

As is customary in Germany, SCM has entered into employment agreements with each of its Named Executive Officers. In connection with the merger of SCM and Hirsch, Mr. Midland entered into an employment agreement with Hirsch, which became effective on the effective date of the merger, April 30, 2009. The terms of this agreement are discussed below under Termination/Change in Control Payments.

In July 2008, SCM Microsystems GmbH, a wholly-owned subsidiary of SCM, entered into supplemental employment agreements (the Supplements) with Mr. Marx and Mr. Rohaly in order to modify certain provisions regarding severance, notice periods and non-competition, primarily to provide them with severance packages comparable to other industry executives. The terms of both Supplements are discussed below under Termination/Change in Control Payments.

On September 30, 2009, SCM Microsystems GmbH entered into a termination agreement with Mr. Rohaly which superseded the supplemental employment agreement discussed above and previously entered into between Mr. Rohaly and SCM. In accordance with the termination agreement, Mr. Rohaly resigned from his various positions with SCM effective September 30, 2009 and will terminate his employment with SCM effective March 31, 2010. Mr. Rohaly is bound by a non-compete obligation with regard to any and all competitive activities through October 31, 2010. Under the termination agreement, Mr. Rohaly is entitled to continue to receive regular salary payments through March 31, 2010, based on his annual base salary of 240,000, and he is entitled to receive 10% of his annual base salary as a quarterly bonus payment for the third quarter of 2009, provided that SCM s corporate performance satisfies the requirements of the 2009 Executive Bonus Plan, including the achievement of operating profit for the fiscal year 2009 third quarter. In addition, as compensation for the loss of his employment and his compliance with the obligation not to compete described above, Mr. Rohaly will receive a lump-sum severance payment in the amount of 360,000 on March 31, 2010. Under German labor practices, Mr. Rohaly is also entitled to receive compensation through March 31, 2010 related to pension contributions and health and unemployment insurance.

Summary of SCM Executive Compensation in 2008

Summary Compensation Table

The following table sets forth certain information with respect to the compensation of SCM s Chief Executive Officer, former Chief Financial Officer, Stephan Rohaly, who resigned from that position as of September 30, 2009, and the executive officers other than the Chief Executive Officer and Chief Financial Officers, based on total compensation earned during fiscal years 2008, 2007 and 2006, for their services with us in all capacities during the 2008, 2007 and 2006 fiscal years.

Name and Principal Position	Year	Salary	Bonus	Option Grants (1)(2)	Non-Equity Incentive Plan Compensation (5)	All Other Compensation	Total
Felix Marx	2008	$ 363,607	$ 333,333(3)	$ 51,458		$ 47,070(13)	$ 795,468
Chief Executive Officer(22)(23)	2007	$ 66,219		$ 2,973	$ 27,264(6)	$ 8,469(14)	$ 104,925
	2006						
Stephan Rohaly	2008	$ 354,659		$ 58,671		$ 30,682(15)	$ 444,012
Chief Financial Officer(22)(24)	2007	$ 313,065	$ 50,000(4)	$ 116,845	$ 62,059(7)	$ 34,385(16)	$ 576,354
	2006	$ 200,896		$ 27,303	$ 57,353(8)	$ 19,693(17)	$ 305,245
Eang Sour Chhor	2008	$ 243,984		$ 12,175	$ 18,717(9)	$ 37,753(18)	$ 312,629
Executive Vice President, Strategy,	2007						
Marketing and Engineering(22)(25)	2006						
Dr. Manfred Mueller	2008	$ 241,658		$ 22,087	$ 60,552(10)	$ 37,311(19)	$ 361,608
Executive Vice President Strategic	2007	$ 202,211	$ 30,000(4)	$ 68,927	$ 56,229(11)	$ 33,283(20)	$ 390,650
Sales and Business Development(22)	2006	$ 178,386		$ 19,797	$ 35,637(12)	$ 35,133(21)	$ 268,953

Option Awards

(1) The amounts in this column represent the expense recognized for financial statement reporting purposes with respect to the fiscal year in accordance with SFAS 123(R). These amounts may reflect options granted in years prior to 2008. Option expense figures are calculated using the Black-Scholes-Merton valuation model using the following assumptions: a dividend rate of zero, an interest rate for the expected life of the option at the date of grant, an expected option life of 4.00 years, and volatility based on historical averages at the date of grant. See Note 2 to the Consolidated Financial Statements for the period ended December 31, 2008 for more information about how SCM accounts for stock-based compensation.

(2)

Reflects both time-based initial or annual options as well as performance-based options to purchase shares of SCM common stock granted under its 1997 Stock Option Plan, its 2000 Stock Option Plan and its 2007 Stock Option Plan, as discussed in Compensation Discussion and Analysis under Compensation Elements: Long-Term Equity Incentives.

Bonus

(3) Reflects special performance bonus in recognition of Mr. Marx s contributions to the company and his performance in 2008, including his efforts to re-position the company and to implement its growth strategy.

(4) Reflects special performance bonuses based on expanded responsibilities during the period following the departure of SCM s former CEO in July 2007 until the hiring of its current CEO in late October 2007.

Non-Equity Incentive Plan Compensation

(5) For 2008, reflects cash bonus awards earned under SCM s 2008 Plan, and in the case of Dr. Mueller, awards earned both under SCM s 2008 Plan and its Sales Commission Plan. For 2007, reflects cash bonus awards earned under SCM s 2007 Plan, and in the case of Dr. Mueller, awards earned both under SCM s 2007 Plan and its Sales Commission Plan. For 2006, reflects cash bonus awards earned under SCM s Management by Objective program, in the case of Messrs. Rohaly and Mueller. These plans are discussed in Compensation Discussion and Analysis under Compensation Elements Incentive Cash Bonuses.

(6) Reflects a cash bonus of 18,581, or 10% of Mr. Marx s annual base salary as prorated for his service from late October through the end of 2007, based on the achievement of operating profit in the fourth quarter of 2007, as determined under SCM s 2007 Plan.

(7) Reflects quarterly bonus awards of 20,000 and 24,000, or 10% of Mr. Rohaly s annual base salary for the first and fourth quarters of 2007, respectively, based on the achievement of operating profitability in those quarters, as determined under SCM s 2007 Plan.

(8) Reflects quarterly performance bonus awards paid to Mr. Rohaly under the SCM Management by Objective program.

(9) Reflects guaranteed bonus payment of 12,000, or 10% of Mr. Chhor s annual base salary, prorated for his February 1, 2008 start date, as specified in Mr. Chhor s employment agreement.

(10) Reflects quarterly cash awards totaling 41,032 for the four quarters of 2008 under SCM s Sales Commission Plan, as discussed in Compensation Discussion and Analysis under Compensation Elements: Incentive Cash Payouts under the Sales Commission Plan.

(11) Reflects a quarterly bonus award of 14,500, or 10% of Dr. Mueller s annual base salary, based on the achievement of operating profitability in the first quarter of 2007 as determined under SCM s 2007 Plan. Also reflects quarterly cash awards totaling 26,133 for the second, third and fourth quarters of 2007, during which periods Dr. Mueller was eligible to receive cash awards under SCM s Sales Commission Plan, as discussed in Compensation Discussion and Analysis under Compensation Elements: Incentive Cash Payouts under the Sales Commission Plan.

(12) Reflects quarterly performance bonus awards under the SCM Management by Objective program and a discretionary bonus awarded to Dr. Mueller for the third quarter of 2006.

All Other Compensation

(13) Reflects payments of 7,750, and 24,887 made on Mr. Marx s behalf in 2008 for a rental apartment in Germany, as Mr. Marx s home is in Austria, and car leasing and insurance expenses, respectively.

(14) Reflects payments of 1,761 and 4,180 made on Mr. Marx s behalf in 2007 for travel between SCM s offices in Germany and Mr. Marx s home in Austria, and car leasing and insurance expenses, respectively.

(15) Reflects payments of 319 and 20,559 made on Mr. Rohaly s behalf in 2008 for pension and employee saving contributions, and car leasing and insurance expenses, respectively.

(16) Reflects payments of 3,454, 1,803 and 20,156 made on Mr. Rohaly s behalf in 2007 for pension and employee saving contributions, health and unemployment insurance, and car leasing expenses, respectively.

(17) Reflects payments of 3,504, 2,339 and 9,807 made on Mr. Rohaly s behalf in 2006 for pension and employee saving contributions, health and unemployment insurance, and car allowance and leasing expenses, respectively.

(18) Reflects payments of 10,078 made on Mr. Chhor s behalf in 2008 for travel between Germany and Mr. Chhor s home in France for February through July 2008 and living allowance August through December 2008; and payments made on Mr. Chhor s behalf in 2008 of 9,859 and 5,400 for pension contributions and health and unemployment insurance, and car allowance, respectively.

(19) Reflects payments of 10,431 and 14,824 made on Dr. Mueller s behalf in 2008 for pension and employee saving contributions and health and unemployment insurance, and car leasing and insurance expenses, respectively.

(20) Reflects payments of 6,588, 3,967 and 13,945 made on Dr. Mueller s behalf in 2007 for pension and employee saving contributions, health and unemployment insurance, and car leasing expenses, respectively.

(21) Reflects payments of 6,462, 4,502 and 17,227 made on Dr. Mueller s behalf in 2006 for pension and employee saving contributions, health and unemployment insurance, and car leasing expenses, respectively.

Exchange Rate

(22) Messrs. Marx, Rohaly, Chhor and Mueller are paid in local currency, which is the Euro. Due to fluctuations in exchange rates during the year, amounts in U.S. dollars varied from month to month. Amounts shown in U.S. dollars under Salary and All Other Compensation above were derived using the average exchange rates for the quarter in which such amounts were earned and paid. Amounts shown in dollars under Non-Equity Incentive Plan Compensation were derived using exchange rates that correspond to the period in which award

payments were made, generally the quarter after they were earned. Average exchange rates for the periods shown in the table above are as follows:

	2006	2007	2008	2009
First Quarter	0.835 per dollar	0.764 per dollar	0.681 per dollar	0.742 per dollar
Second Quarter	0.811 per dollar	0.745 per dollar	0.641 per dollar	0.735 per dollar
Third Quarter	0.786 per dollar	0.736 per dollar	0.649 per dollar	0.699 per dollar
Fourth Quarter	0.785 per dollar	0.701 per dollar	0.745 per dollar	

Other

(23) Mr. Marx joined the company in October 2007.

(24) Mr. Rohaly joined the company in March 2006, and resigned from his position as Chief Financial Officer effective September 30, 2009.

(25) Mr. Chhor joined the company in February 2008, and resigned from his position effective June 30, 2009.

Grant of Plan-Based Awards in Fiscal Year 2008

The following table sets forth certain information with respect to the grant of plan-based awards under SCM s quarterly and annual bonus programs and its stock option plans.

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards(1)(2)	All Other Option Awards; Number of Securities Underlying Options(3)	Exercise or Base Price of Option Awards (Per/Share)	Grant Date Fair Value of Stock and Option Awards (4)
Name	Grant Date	Target			
Felix Marx	02/26/2008		100,000(5)	$ 3.05	$ 135,320
Chief Executive Officer	4/22/2008		19,800(6)	$ 3.12	$ 27,546
		$ 298,895			
Stephan Rohaly	02/26/2008		100,000(5)	$ 3.05	$ 135,320
Chief Financial Officer	4/22/2008		19,800(6)	$ 3.12	$ 27,546
		$ 268,361			
Eang Sour Chhor	02/01/2008		40,000(7)	$ 3.41	$ 60,520
Executive Vice President, Strategy, Marketing and Engineering		$ 191,911			
Dr. Manfred Mueller	4/22/2008		6,500(6)	$ 3.12	$ 19,477

Executive Vice President	4/22/2008		14,000(8)	$ 3.12	$ 9,043
Strategic Sales and		$ 185,045(9)			
Business Development					

(1) Refers to the potential payouts for 2008 under SCM s 2008 Plan, and in the case of Dr. Mueller, SCM s Sales Commission Plan, as further discussed in Compensation Discussion and Analysis. Target amounts are calculated based on 100% achievement of quarterly target bonuses only. Maximum amounts reflect total potential payout based on 100% achievement of both quarterly and annual targets. In the case of Mr. Chhor, potential bonus amounts are prorated based on his length of employment with SCM during 2008. Actual bonus amounts paid to SCM s executives for 2008 are shown in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table.

(2) Amounts shown in dollars are converted from Euros, in which currency SCM s German-based executives are paid, and were derived using exchange rates that correspond to the period in which award payments would typically be made, which generally is the quarter after they were earned. Exchange rates used in this conversion are therefore: 0.641 per dollar for the second quarter of 2008, 0.649 per dollar for the third quarter of 2008, 0.745 per dollar for the fourth quarter of 2008 and 0.742 per dollar for the first quarter of 2009.

(3) During 2008, SCM granted options to its executives under SCM s 2007 Stock Option Plan. All options have an exercise price that is the closing price of SCM common stock on the NASDAQ Stock Market on the date of grant and expire seven years from the date of grant.

(4) The grant date fair value of the options awards is calculated using the Black-Scholes-Merton valuation model using the following assumptions: a dividend rate of zero, an interest rate for the expected life of the option at the date of grant, an expected option life of 4.00 years, and volatility based on historical averages at the date of grant. See Note 2 to the Consolidated Financial Statements in for the period ended December 31, 2008 for more information about how SCM accounts for stock-based compensation.

(5) Reflects option granted in lieu of an annual salary increase for 2008 that vests 100% three years from the grant date.

(6) Reflects annual options that vest 1/48th per month commencing on the date of grant.

(7) Reflects initial options to purchase shares of SCM common stock, granted upon joining SCM. These options vest 25% one year from the date of grant and then vest 1/48th per month for 36 months.

(8) Reflects option grant based on Dr. Mueller s promotion in February 2008 that vests 1/48th per month commencing on the date of grant.

(9) Under SCM s Sales Commission Plan, there is no limit to the amount of bonus that can be earned for the achievement of revenue above target levels.

Outstanding Equity Awards at Fiscal Year-End

The following table sets forth certain information with respect to the outstanding equity awards held by the Named Executive Officers at the end of 2008.

			Option Awards		
Name	**Grant Date**	**Number of Securities Underlying Unexercised Options Exercisable**	**Number of Securities Underlying Unexercised Options Unexercisable**	**Option Exercise Price**	**Option Expiration Date**
Felix Marx	10/22/2007	14,583	35,417(1)	$ 2.98	10/22/2017
Chief Executive Officer	10/22/2007	2,916	7,084(1)	$ 2.98	10/22/2014
	02/26/2008	0	100,000(2)	$ 3.05	02/26/2015
	04/22/2008	3,300	16,500(3)	$ 3.12	04/22/2015
Stephan Rohaly	3/14/2006	20,625	9,375(1)	$ 3.21	3/14/2016
Chief Financial Officer	9/28/2006	50,000	0(4)	$ 3.41	9/28/2016
	2/14/2007	20,000	0(4)	$ 4.02	2/14/2017
	3/23/2007	0	19,800(5)	$ 4.34	3/23/2017
	02/26/2008	0	100,000(2)	$ 3.05	02/26/2015
	04/22/2008	3,300	16,500(3)	$ 3.12	04/22/2015
Eang Sour Chhor	02/01/2008	0	40,000(1)	$ 3.41	02/01/2015
Executive Vice President, Strategy, Marketing and Engineering					
Dr. Manfred Mueller	7/17/2001	20,000	0(1)	$ 8.08	7/17/2011

Executive Vice President	4/16/2003	3,329	0(5)	$	3.31	4/16/2013
Strategic Sales and Business Development	4/16/2003	3,832	0(4)	$	3.31	4/16/2013
	9/16/2004	1,500	4,500(5)	$	2.78	9/16/2014
	9/16/2004	5,000	0(4)	$	2.78	9/16/2014
	7/27/2005	0	6,000(5)	$	3.08	7/27/2015
	2/02/2006	5,000	0(4)	$	3.23	2/02/2016
	7/05/2006	0	6,200(5)	$	3.03	7/05/2016
	9/28/2006	20,000	0(4)	$	3.41	9/28/2016
	2/14/2007	20,000	0(4)	$	4.02	2/14/2017
	3/23/2007	0	6,500(5)	$	4.34	3/23/2017
	04/22/2008	1,083	5,417(3)	$	3.12	04/22/2015
	04/22/2008	2,333	11,667(3)	$	3.12	04/22/2015

(1) Vests 25% after one year, then 1/48th vests monthly for 36 months.

(2) Vests 100% three years from date of grant.

(3) Vests 1/48th per month from date of grant.

(4) Vests 100% one year from date of grant.

(5) Vests 1/12th per month over one year, commencing four years from date of grant.

Pension Benefits

SCM does not offer pension benefits and has, therefore, omitted the Pension Benefits table. As described in Compensation Discussion and Analysis, on behalf of SCM s executives in Germany, SCM makes payments to a government-managed pension program, to government-managed or private health insurance programs, and in some cases for unemployment insurance, as mandated under German employment law. These payments are detailed under the All Other Compensation column of the Summary Compensation Table. Any use of the term pension in the Compensation Discussion and Analysis or the related tables is a reference to the German government-managed pension program.

Termination/Change in Control Payments

The information below describes certain compensation that would have become payable under contractual arrangements assuming a termination of employment occurred on December 31, 2008, based upon the Named Executive Officers compensation and service levels as of such date.

SCM has entered into employment agreements containing severance provisions with each of its current and former executive officers. Below are the material terms of each agreement. None of SCM s current or former executive officers included below are of retirement age and none of their respective agreements contain provisions for additional payments upon retirement. SCM does not offer its executive officers severance benefits in the case of death, disability or voluntary termination.

Following any termination, each of the agreements described below requires the Named Executive Officer to keep as secret all confidential information related to SCM, including, but not limited to, operational and business secrets.

Employment Agreements

Employment Agreement with Felix Marx

On July 31, 2007, through SCM s wholly-owned subsidiary, SCM Microsystems GmbH, SCM entered into an employment agreement with Felix Marx, who became SCM s Chief Executive Officer and Managing Director of SCM Microsystems GmbH, effective October 22, 2007. Either party may terminate the agreement with six months prior written notice.

On July 30, 2008, through SCM Microsystems, GmbH, SCM entered into a supplemental employment agreement with Mr. Marx that amends his employment agreement and modifies certain provisions regarding severance, notice periods and non-competition. Under the supplementary employment agreement, if Mr. Marx is given ordinary notice of termination by SCM without Mr. Marx having given prior notice of termination or having caused SCM to give such notice as a result of severe and avoidable misconduct, then Mr. Marx will be eligible to receive a one-time severance payment equal to 12 months of his then-current monthly salary and a bonus payment under SCM s Executive Bonus

Plan equal to 40% of his then-current annual salary.

The supplementary employment agreement further provides that either Mr. Marx or SCM may terminate Mr. Marx s employment agreement by providing 12 months written notice. In the event of termination by SCM, Mr. Marx may be required to continue to perform his responsibilities for SCM only for a period of up to three months, excluding unused holiday hours, after which he will be released from his employment. Any remainder of the 12-month notice period following release from employment (from nine to 12 months) is the release period, during which Mr. Marx would continue to receive his then-current monthly salary and a fixed bonus payment under SCM s Executive Bonus Plan equal to 40% of his then current annual salary. Such remuneration during the release period would be in addition to the one-time severance payment described above. In the event of notice of termination by Mr. Marx, he may be required to continue to perform his responsibilities for SCM for up to the entire 12-month notice period, during which time he would continue to receive regular salary payments and remain eligible for bonus payments under SCM s Executive Bonus Plan, and thereafter would not be eligible for any further remuneration or the severance payments described above.

Additionally, following any ordinary notice of termination given by SCM to Mr. Marx, during the release period Mr. Marx would continue to be prohibited from engaging in any other employment, occupation, consulting or other business activity competitive with or related to the current or future business of SCM. He would also be prohibited from acquiring, obtaining an equity interest in or otherwise supporting any enterprise which engages in business activity competitive with or related to the current or future business of SCM.

If Mr. Marx had been terminated by SCM for any reason other than for severe and avoidable misconduct, as of December 31, 2008, under his employment agreement, he would have been entitled to receive a severance payment of 280,000, a release period payment of 280,000, a bonus payment of 112,000, and other compensation of 32,437 related to apartment rental and car leasing and insurance expenses, or approximately $898,516, based on the average exchange rate for December 2008 of one U.S. dollar being equal to 0.784 Euros.

Additionally, under German labor practices, Mr. Marx might also have been entitled to receive quarterly or annual bonus payments, the amount of which would be determined based on a variety of factors, including his length of service and perceived contributions to past or future company performance.

Following any termination, under his employment agreement, Mr. Marx is subject to a two-year non-solicitation provision.

Employment Agreements with Stephan Rohaly

On March 14, 2006, through SCM s wholly-owned subsidiary, SCM Microsystems GmbH, SCM entered into an employment agreement with Stephan Rohaly, who became SCM s Chief Financial Officer on March 21, 2006. Either Mr. Rohaly or SCM Microsystems GmbH could terminate the agreement and Mr. Rohaly s employment with SCM upon at least six months prior written notice.

If Mr. Rohaly had been terminated by SCM for any reason other than for severe and avoidable misconduct as of December 31, 2008, under his employment agreement, he would have been entitled to receive a severance payment of 240,000, a release period payment of 240,000, a bonus payment of 96,000, and other compensation of 20,878 related to pension and employee saving contributions and car leasing and insurance expenses, or approximately $761,324, based on the average exchange rate for December 2008 of one U.S. dollar being equal to 0.784 Euros. Additionally, under German labor practices, Mr. Rohaly might also have been entitled to receive quarterly or annual bonus payments, the amount of which would be determined based on a variety of factors, including his length of service and perceived contributions to past or future company performance.

On July 30, 2008, through SCM Microsystems GmbH, SCM entered into a supplemental employment agreement with Mr. Rohaly that amended his employment agreement and modified certain provisions regarding severance, notice periods and non-competition. On September 30, 2009, SCM Microsystems GmbH entered into a termination agreement with Mr. Rohaly which superseded the supplemental employment agreement. In accordance with the termination agreement, Mr. Rohaly resigned from his various positions with SCM effective September 30, 2009 and will terminate his employment with SCM effective March 31, 2010. Mr. Rohaly is bound by a non-compete obligation with regard to any and all competitive activities through October 31, 2010. Under the termination agreement, Mr. Rohaly is entitled to continue to receive regular salary payments through March 31, 2010, based on his annual base salary of 240,000, and he is entitled to receive 10% of his annual base salary as a quarterly bonus payment for the third quarter of 2009, provided that SCM s corporate performance satisfies the requirements of the 2009 Executive Bonus Plan, including the achievement of operating profit for the fiscal year 2009 third quarter. In addition, as compensation for the loss of his employment and his compliance with the obligation not to compete described above, Mr. Rohaly will receive a lump-sum severance payment in the amount of 360,000 on March 31, 2010. Under German labor practices, Mr. Rohaly is also entitled to receive compensation through March 31, 2010 related to pension contributions and health and unemployment insurance.

Employment Agreement with Eang Sour Chhor

On January 21, 2008, through SCM s wholly-owned subsidiary, SCM Microsystems GmbH, SCM entered into an employment agreement with Sour Chhor, who became SCM s Executive Vice President, Strategy, Marketing and Engineering effective February 1, 2008. Under the employment agreement, either party could terminate Mr. Chhor s employment with three months prior written notice. Mr. Chhor was also subject to the provisions of German labor practices concerning the payment of bonus following notice of termination as described above.

If either SCM or Mr. Chhor had provided notice of termination as of December 31, 2008, under his employment agreement and German labor practices, he would have been entitled to receive a release period payment of 45,000, a bonus payment of 18,000, and other compensation of 5,395 related to living allowance, pension contributions, and health and unemployment insurance, or approximately $87,238, based on an average exchange rate for December 2008 of one U.S. dollar being equal to 0.784 Euros.

Mr. Chhor resigned from his position at SCM on February 6, 2009, effective June 30, 2009. In accordance with the terms of his employment agreement, he received a release period payment of 45,000, a bonus payment of 18,000, and other compensation of 5,395 related to living allowance, pension contributions, and health and unemployment insurance, or approximately $90,951, based on an average exchange rate for June 2009 of one U.S. dollar being equal to 0.752 Euros.

Employment Agreement with Dr. Manfred Mueller

On June 8, 2006, through SCM s wholly-owned subsidiary, SCM Microsystems GmbH, SCM entered into an amended employment agreement with Dr. Manfred Mueller, currently SCM s Executive Vice President, Strategic Sales and Business Development. Either Dr. Mueller or SCM may terminate the agreement and Dr. Mueller s employment with SCM upon at least six months prior written notice. Additionally, should Dr. Mueller be terminated without having caused SCM to give such notice as a result of severe and avoidable misconduct, he is also entitled to receive a severance payment at the time of termination equal to 12 months of his then-current base salary and target bonus of 40% of his then-current annual base salary, payable in a lump sum by SCM Microsystems GmbH.

If Dr. Mueller had been terminated by SCM for any reason other than severe and avoidable misconduct as of December 31, 2008, he would have been entitled to receive a release period payment of 84,000, a severance payment of 168,000, a bonus payment of 67,200, and other compensation of 12,628 related to pension and employee saving contributions, health and unemployment insurance and car leasing expenses, or approximately $423,249. Figures in dollars are based on the average exchange rate for December 2008 of one U.S. dollar being equal to 0.784 Euros.

Employment Agreement with Lawrence W. Midland

On December 10, 2008, through Hirsch, Lawrence W. Midland entered into an employment agreement that became effective upon the completion of the merger of SCM and Hirsch on April 30, 2009. Hirsch may terminate the agreement and Mr. Midland s employment upon at least three months prior written notice. If Mr. Midland s employment is terminated by Hirsch without cause, Mr. Midland shall be entitled to receive, in addition to any accrued benefit rights and subject to execution of a standard release of claims in favor of Hirsch, a payment equal to six months of current base salary, or if Mr. Midland terminates employment for good reason, Mr. Midland shall be entitled to receive, in addition to any accrued benefit rights and subject to execution of a standard release of claims in favor of Hirsch, a payment equal to three months of current base salary.

Compensation Committee Interlocks and Insider Participation

During 2008, the Compensation Committee of SCM s board of directors was comprised of Messrs. Hultzsch, Koepf, Liebler and Turner, with Dr. Liebler joining the committee in July 2008. Dr. Hultzsch served as Chairman of the Compensation Committee from April 2007 until his resignation from the Board and the committee in April 2009. In June 2009, Mr. Morgan joined the Compensation Committee and Dr. Liebler was named Chairman of the committee. Currently, the Compensation Committee consists of Messrs. Koepf, Liebler, Morgan and Turner, and

Mr. Liebler serves as Chairman. SCM s board of directors has determined that each member of the Compensation Committee during 2008 was independent within the meaning of the NASDAQ Stock Market director independence standards.

Equity Compensation Plan Information

The following table summarizes information as of December 31, 2008 about SCM common stock that may be issued upon the exercise of options, warrants and rights granted to employees, consultants or members of its board of directors under all of SCM s existing equity compensation plans, including SCM s 1997 Stock Plan, Director Plan, 1997 Employee Stock Purchase Plan (the Employee Stock Purchase Plan), 2000 Nonstatutory Stock Option Plan (the Nonstatutory Plan) and 2007 Stock Option Plan. Each of the 1997 Stock Plan, Director Plan and Employee Stock Purchase Plan expired in March 2007 and no additional awards will be granted under such plans.

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column(a))
Equity compensation plans approved by stockholders(1)	1,328,845	$ 7.7219	924,591
Equity compensation plans not approved by security holders(2)	499,828	$ 3.3208	210,628
Total(3)	1,828,673	$ 6.5189	1,135,219

(1) Equity plans approved by stockholders consist of the 2007 Stock Option Plan, the 1997 Stock Plan, the Director Plan and the Employee Stock Purchase Plan.

(2) Equity plans not approved by stockholders consist of the Nonstatutory Plan.

(3) Does not include options to purchase an aggregate of 8,018 shares of SCM common stock awarded under Dazzle Multimedia plans prior to SCM s acquisition of Dazzle Multimedia in 2000. These options have a weighted average exercise price of $4.368 and were granted under plans assumed in connection with transactions under which no additional options may be granted.

Material Features of Plans Not Approved by Stockholders

Under the Nonstatutory Plan, non-qualified stock options may be granted to SCM s employees, including officers, and to non-employee consultants. The plan s administrators, as delegated by SCM s board of directors, may set the terms for each option grant made under the plan, including the rate of vesting, allowable exercise dates and the option term of such options granted. The exercise price of a stock option under the Nonstatutory Plan shall be equal to the fair market value of SCM common stock on the date of grant. While SCM s board of directors or its appointed committee may, at its discretion, reduce the exercise price of any option to the then current fair market value if the fair market value of SCM common stock covered by such option shall have declined since the date the option was granted, no such action has ever been taken by SCM s board of directors. 750,000 shares are reserved for issuance under the Nonstatutory Plan, and options for 1,221,736 shares have been granted under the plan to date.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

SCM Related Party Transactions

The Audit Committee of SCM s board of directors, among its other duties and responsibilities, reviews and monitors all related party transactions, and in November 2008 it adopted changes to SCM s Related Party Transaction Policies and Procedures (the Policy). Under the Policy, SCM s board of directors is required to review and approve the material terms of all Interested Transactions involving a related party (including directors, director nominees, executive officers, greater-than-5% beneficial owners, and their respective immediate family members), subject to certain exceptions. An Interested Transaction is any transaction, arrangement or relationship or series of similar transactions, arrangements or relationships (including any indebtedness or guarantee of indebtedness) in which (1) the aggregate amount involved will or may be expected to exceed $100,000 per year or $30,000 in any quarter, (2) the company is a participant and (3) any related party has or will have a direct or indirect interest (other than solely as a result of being a director or a less than 10 percent beneficial owner of another entity). In determining whether to approve or ratify an Interested Transaction, SCM s board of directors is required to take into account, among other factors it deems appropriate, whether the Interested Transaction is on terms no less favorable than terms generally available to an unaffiliated third-party under the same or similar circumstances and the extent of the related person s interest in the transaction.

Exceptions to the Policy include Interested Transactions for which standing pre-approval has been authorized, such as the hiring of executive officers and the payment of compensation to directors, where such compensation is required to be disclosed in SCM s annual, quarterly or current filings with the Securities and Exchange Commission; transactions involving competitive bids; and regulated transactions, such as for the rendering of regulated services, for example with a public utility. At least annually, a summary of new transactions covered by the standing pre-approvals described above is provided to the Committee for its review.

To ensure the Policy is being followed, SCM requires each of its non-employee directors and each of its executive officers to provide and update information about related party relationships and related party transactions on a quarterly and annual basis. This information is reviewed by SCM s corporate accounting personnel, which also reviews its sales and purchasing transactions on an ongoing basis to identify any transactions with known related parties.

SCM s Policy is in writing and has been communicated by management to all SCM employees.

Werner Koepf, SCM s current Chairman of the Board, also served until June 2007 as a director and as a member of the Audit Committee and the Compensation Committee of Gemplus International S.A., a company engaged in the development and distribution of smart-card based systems. During 2007, SCM incurred license expenses of approximately $0.1 million to Gemplus. Approximately $80,000 of this amount related to continuing operations. License expenses of approximately $0.2 million and $0.4 million were incurred for 2006 and 2005, respectively, of which approximately $76,000 and $232,000 related to continuing operations. As of December 31, 2007 and as of December 31, 2005, no accounts payable were due to Gemplus. As of December 31, 2006, approximately $30,000 was due as accounts payable to Gemplus. During 2007, SCM realized revenue of approximately $0.2 million from sales to Gemplus. Revenues of approximately $11,000 and $0 were realized for 2006 and 2005, respectively. As of December 31, 2007 and as of December 31, 2005, no accounts receivable were outstanding from Gemplus. As of December 31, 2006, approximately $11,000 was due as accounts receivable from Gemplus. SCM s business relationship with Gemplus has been in existence for many years and predates Werner Koepf s appointment to the Company s Board of Directors in February 2006. Mr. Koepf was not directly compensated for revenue transactions between the two companies. The related-party transactions have been performed following at arm s length principles.

Other Existing Relationships and Agreements

On May 20, 2009, SCM and Arygon Technologies AG, a Bluehill ID Group Company, entered into a technology and distribution agreement under which the Bluehill ID Group Companies would distribute SCM contact smart card reader technology on an OEM basis and SCM would have access to Bluehill ID s dual antenna RFID reader technology.

Substantial Stockholders of SCM

As of September 30, 2009, Bluehill ID beneficially owned and had the right to vote 1,201,004 shares of SCM common stock and Ayman Ashour, Bluehill ID s CEO and President of its board of directors, beneficially owned 104,000 shares, Bluehill ID and Mr. Ashour, collectively, beneficially owned approximately 5.2% of the currently outstanding shares of SCM common stock. Accordingly, as a party to the business combination, Bluehill ID not only has a significant interest in the outcome of the SCM special meeting of its stockholders to consider the proposal to approve the Offer and, specifically, the issuance of the shares of SCM common stock in connection with the Offer, it may also influence whether a quorum is achieved at the SCM special meeting of its stockholders (as a quorum for any meeting of SCM s stockholders is one-third of all of the shares of SCM entitled to vote), and the outcome of the proposals being considered at the SCM special meeting. The board of directors of Bluehill ID, including Messrs. Ashour and Wenzel and Dr. Boersch, will have the power to determine how the shares of SCM common stock held by Bluehill ID will be voted at the SCM special meeting of its stockholders. Bluehill ID may have objectives and interests that are different than those of SCM s other stockholders.

As of September 30, 2009, Lincoln Vale beneficially owned and had the right to vote approximately 6.1% of the outstanding shares of SCM common stock. As of October 1, 2009, Lincoln Vale also beneficially owned approximately 9.8% of the outstanding bearer shares in Bluehill ID. Upon the closing of the Offer, it is anticipated that Lincoln Vale will beneficially own approximately 7.8% of the outstanding shares of SCM common stock. Dr. Hans Liebler, one of SCM s directors, is a partner of Lincoln Vale and may be deemed to beneficially own, either directly or indirectly through limited partnerships, the shares beneficially owned by Lincoln Vale. As a substantial holder of both SCM and Bluehill ID, Lincoln Vale may have objectives and interests that are different than those of SCM s other stockholders.

In addition, immediately after the closing of the Offer, it is anticipated that Bluehill ID s largest shareholder, Mountain Partners AG, together with its affiliates and certain related parties, including BH Capital Management AG, Daniel S. Wenzel and Dr. Cornelius Boersch, will directly or indirectly beneficially own approximately 25.2% of the outstanding shares of SCM common stock; and Ayman S. Ashour, Bluehill ID s Chief Executive Officer and President of its board of directors, will directly or indirectly beneficially own, including through BH Capital Management AG, approximately 10.8% of the outstanding shares of SCM common stock. Mr. Wenzel and Dr. Boersch, who currently serve as directors of Bluehill ID and Mountain Partners AG, and Mr. Ashour are expected to be appointed to SCM s board of directors following the closing of the Offer. Accordingly, Mr. Ashour, Mountain Partners AG, Mr. Wenzel and Dr. Cornelius Boersch will have significant influence over the outcome of corporate actions requiring board and stockholder approval.

MATERIAL UNITED STATES FEDERAL INCOME TAX CONSEQUENCES OF THE BUSINESS COMBINATION

The following is a summary of the material U.S. federal income tax consequences of the Offer to SCM stockholders and Bluehill ID shareholders. It is based on provisions of the U.S. Internal Revenue Code of 1986, as amended (the Code), existing and proposed Treasury regulations promulgated thereunder (the Treasury Regulations) and administrative and judicial interpretations thereof, all as of the date hereof and all of which are subject to change, possibly on a retroactive basis. This summary does not address all of the U.S. federal income tax consequences that may be relevant to a particular holder of SCM common stock or bearer shares in Bluehill ID in light of their personal circumstances, or to certain types of holders that may be subject to special tax treatment (including, but not limited to, banks and other financial institutions, employee stock ownership plans, partnerships or other pass-through entities for U.S. federal income tax purposes, certain former citizens or residents of the United States, controlled foreign corporations, foreign personal holding companies, corporations that accumulate earnings to avoid U.S. federal income tax, insurance companies, tax-exempt organizations, dealers in securities, brokers, regulated investment companies, traders in securities who elect the mark to market method of accounting for their securities, or holders of SCM common stock or bearer shares in Bluehill ID who hold their securities as part of a straddle, hedge, conversion transaction or other integrated transaction). In addition, this summary does not include any description of the tax laws of any state, local or non-U.S. government that may be applicable to a particular holder of SCM common stock or bearer shares in Bluehill ID and does not consider any aspects of U.S. federal tax law other than income taxation. No assurance can be given that the Internal Revenue Service would not assert, or that a court would not sustain, a position contrary to any of the tax consequences set forth below. This discussion is limited to taxpayers who hold their bearer shares in Bluehill and will hold their shares of SCM common stock as capital assets within the meaning of Section 1221 of the Code (generally, property held for investment).

A U.S. Holder is a beneficial owner of bearer shares in Bluehill ID or SCM common stock that is for United States federal income tax purposes: (a) an individual citizen or resident of the United States, (b) a corporation (or any other entity treated as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States, any state thereof or the District of Columbia, (c) an estate whose income is subject to United States federal income tax regardless of its source, or (d) a trust if a United States court can exercise primary supervision over the trust s administration and one or more United States persons are authorized to control all substantial decisions of the trust or if the trust has a valid election in effect to be treated as a United States person. A non-U.S. Holder is a beneficial owner of bearer shares in Bluehill ID or SCM common stock (other than an entity or arrangement treated as a partnership for U.S. federal income tax purposes) that is not a U.S. Holder.

If a partnership (or other entity treated as a partnership for U.S. federal income tax purposes) is a holder of SCM common stock or bearer shares in Bluehill ID, the tax treatment of a partner in the partnership or any equity owner of such other entity will generally depend upon the status of the person and the activities of the partnership or other entity treated as a partnership for U.S. federal income tax purposes.

Consequences to SCM and Bluehill ID

Neither SCM nor Bluehill ID will recognize a gain or loss as a result of the consummation of the Offer.

Consequences to Holders of SCM Common Stock

Holders of SCM common stock will not recognize any gain or loss as a result of the Offer.

U.S. Holders of Bearer Shares in Bluehill ID

Consequences of the Exchange

The U.S. federal income tax treatment of U.S. Holders of bearer shares in Bluehill ID who exchange their bearer shares in Bluehill ID for shares of SCM common stock pursuant to the Offer will depend on whether the exchange constitutes a reorganization under Section 368 of the Code. In general, the exchange will qualify as a reorganization if SCM acquires at least 80% of the bearer shares in Bluehill ID and certain other technical requirements of Section 368 are satisfied, including that the bearer shares in Bluehill ID are considered to be exchanged solely for voting stock of SCM and that the Bluehill ID shareholders receive a sufficient amount of SCM common stock to satisfy the continuity of interest test set forth in the Treasury regulations promulgated under Section 368.

If the consummation of the Offer constitutes a reorganization, U.S. Holders of bearer shares in Bluehill ID who exchange bearer shares in Bluehill ID solely for SCM common stock pursuant to the Offer will not recognize gain or loss in the exchange. The Bluehill ID shareholders will receive an aggregate tax basis in the SCM common stock received pursuant to the Offer equal to the aggregate tax basis in the shares of SCM common stock surrendered in the transaction. The holding period of the SCM common stock received in the Offer by a U.S. Holder of bearer shares in Bluehill ID will include the holding period of the bearer shares in Bluehill ID that he or she surrendered in exchange therefor. If a U.S. Holder of bearer shares in Bluehill ID has differing tax bases and/or holding periods in respect of the shareholder s bearer shares in Bluehill ID, the Bluehill ID shareholder should consult with a tax advisor in order to identify the tax bases and/or holding periods of the particular shares of SCM common stock that the Bluehill ID shareholder receives pursuant to the Offer.

If for any reason the consummation of the Offer fails to qualify as a reorganization, the consummation of the Offer would be a fully taxable transaction to U.S. Holders of bearer shares in Bluehill ID. In such case, U.S. Holders of bearer shares in Bluehill ID would recognize gain or loss measured by the difference between the value of the SCM common stock received by them in the Offer and their tax basis in the bearer shares in Bluehill ID surrendered in the Offer. The aggregate tax basis in the SCM common stock received pursuant to the Offer will be equal to the fair market value of such stock at the time of the consummation of the Offer. The holding period of such SCM common stock will begin on the date immediately following the date of the consummation of the Offer.

Distributions With Respect to the SCM Common Stock

Distributions with respect to the SCM common stock (other than certain stock distributions) will be taxable as dividend income when actually or constructively received to the extent of the current or accumulated earnings and profits of SCM as determined for U.S. federal income tax purposes. To the extent that the amount of a distribution with respect to the SCM common stock exceeds both SCM s current and accumulated earnings and profits, such distribution will be treated first as a tax-free return of capital to the extent of a U.S. Holder s adjusted tax basis in such SCM common stock and thereafter as capital gain.

Subject to certain exceptions for short-term and hedged positions, distributions constituting dividend income received by certain non-corporate U.S. Holders, including individuals, in respect of the SCM common stock in taxable years beginning before January 1, 2011, are generally taxed at a maximum rate of 15%. Similarly, subject to certain exceptions for short-term and hedged positions, distributions on the SCM common stock constituting dividend income paid to corporate U.S. holders generally will qualify for the dividends received deduction. The benefits of the dividends received deduction to a corporate U.S. Holder may, in effect, be reduced or eliminated by many exceptions and restrictions, including restrictions relating to the corporate U.S. Holder s taxable income, holding period of the stock, and the so-called extraordinary dividend provision of Section 1059 of the Code. U.S. Holders should consult their own tax advisors regarding the availability of the reduced dividend tax rate or the dividends received deduction in light of their particular circumstances.

Sales, Exchanges, Redemptions and Other Dispositions of the SCM Common Stock

If a U.S. Holder sells or otherwise disposes of the SCM Common Stock (other than pursuant to a redemption transaction), such U.S. Holder will generally recognize capital gain or loss equal to the difference between the amount realized and the U.S. Holder s adjusted tax basis in the stock. Such capital gain or loss will be long-term capital gain or loss if the U.S. Holder s holding period for the shares is more than one year. Long-term capital gain of a noncorporate U.S. Holder that is recognized in taxable years beginning before January 1, 2011 is generally taxed at a maximum rate of 15%. The deductibility of net capital losses is subject to limitations.

If a U.S. Holder sells or otherwise disposes of the SCM common stock pursuant to a redemption transaction, such U.S. Holder generally will recognize capital gain or loss on the redemption provided the redemption meets at least one of the following requirements as determined under U.S. federal income tax principles: (1) the redemption is not essentially equivalent to a dividend; (2) the redemption results in a complete termination of such holder s interest in the SCM common stock; or (3) the redemption is substantially disproportionate with respect to such holder. In determining whether any of the above requirements applies, SCM common stock considered to be owned by a U.S. Holder by reason of certain attribution rules must be taken into account. If the redemption satisfies any of the above requirements, the U.S. Holder s gain or loss will be determined in the same manner as if the U.S. Holder disposed of the SCM common stock in a taxable disposition. If the redemption does not satisfy any of the above requirements, then the entire amount received (without offset for the U.S. Holder s tax basis in the stock redeemed) will be treated as a distribution as described above under Distributions with Respect to the SCM Common Stock.

Information Reporting and Backup Withholding

Certain U.S. Holders of bearer shares in Bluehill ID may be subject to information reporting with respect to the SCM common stock received in exchange for bearer shares in Bluehill ID pursuant to the Offer. In addition, information reporting requirements generally will apply to payments qualifying as dividends on the SCM common stock and, unless the U.S. Holder receiving such amounts is an exempt recipient such as a corporation, to the proceeds of a sale or redemption of shares of SCM common stock. U.S. Holders who are subject to information reporting and who do not provide appropriate information when requested may also be subject to backup withholding. Any amount withheld under such rules is not an additional tax and may be refunded or credited against such Bluehill ID shareholders federal income tax liability, provided that the required information is properly furnished in a timely manner to the Internal Revenue Service.

Non-U.S. Holders of Bearer Shares in Bluehill ID

Consequences of the Exchange

A non-U.S. Holder of bearer shares in Bluehill ID will not recognize income, gain or loss for U.S. federal tax purposes pursuant to the Offer, unless the holder is an individual, is present in the United States for 183 or more days in the taxable year of the sale, and certain other conditions exist, in which case the holder will be subject to a flat 30% U.S. federal income tax on the gain derived from the sale, which may be offset by U.S. source capital losses.

Distributions With Respect to SCM Common Stock

Any distribution to a non-U.S. Holder with respect to the SCM common stock that is treated as a dividend for U.S. federal income tax purposes (including any redemptions that are treated as dividend distributions will be subject to withholding of United States federal income tax at a 30% rate or at a lower (or zero) rate if the non-U.S. Holder is eligible for the benefits of an income tax treaty that provides for a lower rate. For purposes of obtaining a reduced rate of withholding under an income tax treaty, a non-U.S. Holder generally will be required to provide a valid Internal Revenue Service Form W-8BEN or an acceptable substitute form. If, however, dividends paid to a non-U.S. Holder are effectively connected with the non-U.S. Holder s conduct of a trade or business within the United States (and, if an income tax treaty applies, are attributable to a U.S. permanent establishment maintained by the non-U.S. Holder), SCM is generally not required to withhold tax from the dividends, provided that the non-U.S. Holder has furnished to SCM a valid Internal Revenue Service Form W-8ECI. Effectively connected dividends are taxed at rates applicable to U.S. Holders, unless an applicable income tax treaty provides otherwise. If a non-U.S. Holder is a corporate non-U.S. Holder, effectively connected dividends that the non-U.S. Holder receives may, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or at a lower rate if the non-U.S. Holder is eligible for the benefits of an income tax treaty that provides for a lower rate.

Sale, Exchange, Redemption or other Disposition of the SCM Common Stock

If gain is realized by a non-U.S. Holder upon the sale, exchange, redemption that is treated as a sale or exchange, or other taxable disposition of the SCM common stock, the non-U.S. Holder will generally only be subject to U.S. federal income tax on such gain if:

the gain is effectively connected with the holder s conduct of a trade or business in the United States, and if required by an applicable income tax treaty as a condition for subjecting the holder to United States taxation on a net income basis, the gain is attributable to a permanent establishment that the holder maintains in the United States, the holder is an individual, is present in the United States for 183 or more days in the taxable year of the sale, and certain other conditions exist, or

SCM is or has been a United States real property holding corporation for federal income tax purposes at any time within the shorter of the five-year period preceding such disposition or your holding period. SCM does not believe that it is, has been, or will be a United States real property holding corporation for United States federal income tax purposes.

A non-U.S. Holder described in the first bullet point above will be subject to U.S. federal income tax on the net gain derived from the sale in the same manner as a U.S. Holder. If a non-U.S. Holder is eligible for the benefits of a tax treaty between the United States and its country of residence, any such gain will be subject to U.S. federal income tax in the manner specified by the treaty and generally will only be subject to such tax if such gain is attributable to a permanent establishment maintained by the non-U.S. Holder in the United States. To claim the benefit of a treaty, a non-U.S. Holder must properly submit an IRS Form W 8BEN (or suitable successor or substitute form). A non-U.S. Holder that is a foreign corporation and is described in the first bullet point above will be subject to tax on gain under regular graduated U.S. federal income tax rates and, in addition, may be subject to a branch profits tax at a 30% rate or a lower rate if so specified by an applicable income tax treaty. An individual non-U.S. Holder described in the second bullet point above will be subject to a flat 30% U.S. federal income tax on the gain derived from the sale, which may be offset by U.S. source capital losses, even though the holder is not considered a resident of the United States.

Information Reporting and Backup Withholding

Information reporting will generally apply to dividend payments on the SCM common stock. Copies of these information reports may be made available to tax authorities in the country in which the non-U.S. Holder resides. A non-U.S. Holder will be subject to backup withholding with respect to dividends paid to such holder unless such holder certifies under penalty of perjury that it is not a U.S. person (and the payor does not have actual knowledge or reason to know that such holder is a United States person as defined under the Code), or such holder otherwise establishes an exemption. Information reporting and, depending on the circumstances, backup withholding will apply to the proceeds of a sale of the SCM common stock within the United States or conducted through certain United States-related financial intermediaries, unless the beneficial owner certifies under penalty of perjury that it is not a U.S. person (and the payor does not have actual knowledge or reason to know that the beneficial owner is a United States person as defined under the Code) or such owner otherwise establishes an exemption.

Any amounts withheld under the backup withholding rules will be allowed as a refund or a credit against a non-U.S. Holder s United States federal income tax liability provided the required information is furnished to the Internal Revenue Service.

Other Taxation Considerations for Holders of Bearer Shares in Bluehill ID

The taxation discussion set forth below is intended only as a descriptive summary and does not purport to be a complete analysis or listing of all potential tax effects relevant to the ownership or disposition of bearer shares in Bluehill ID. It is not deemed to be an analysis with regard to the Swiss tax consequences in connection with the Offer. The statements of United States and Swiss tax laws set forth below are based on the laws and regulations in force as of the date of this proxy statement and prospectus, including the current Convention Between the United States and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, entered into force on December 19, 1997 (the Treaty), and the U.S. Internal Revenue Code of 1986, as amended (the Code), Treasury regulations, rulings, judicial decisions and administrative pronouncements, and may be subject to any changes in

U.S. and Swiss law, and in any double taxation convention or treaty between the United States and Switzerland occurring after that date, which changes may have retroactive effect.

Recipients of dividends and similar distributions on the bearer shares in Bluehill ID who are neither residents of Switzerland for tax purposes nor holding shares as part of a business conducted through a permanent establishment situated in Switzerland (Non-resident Holders) are not subject to Swiss income taxes in respect of such distributions. Moreover, gains realized by such recipients upon the disposal of shares are not subject to Swiss income taxes.

Dividends and similar distributions to Non-resident Holders of shares are, however, subject to Withholding Tax mentioned above and Non-resident Holders of shares may under certain circumstances be subject to the Stamp Duty described below. Such Non-resident Holders may be entitled to a partial refund of the Withholding Tax if the country in which they reside has entered into a bilateral treaty for the avoidance of double taxation with Switzerland. Non-resident Holders should be aware that the procedures for claiming treaty refunds (and the time frame required for obtaining a refund) may differ from country to country. Non-resident Holders should consult their own tax advisors regarding receipt, ownership, purchase, sale or other dispositions of shares or ADSs and the procedures for claiming a refund of the Withholding Tax.

A Non-resident Holder of shares will not be liable for any Swiss taxes other than the Withholding Tax described above and, if the transfer occurs through or with a Swiss bank or other Swiss securities dealer, the Stamp Duty described below. If, however, the shares of Non-resident Holders can be attributed to a permanent establishment or a fixed place of business maintained by such person within Switzerland during the relevant tax year, the shares may be subject to Swiss income taxes in respect of income and gains realized on the shares and such person may qualify for a full refund of the Withholding Tax based on Swiss tax law.

Residents of the United States

A Non-resident Holder who is a resident of the United States for purposes of the Treaty is eligible for a reduced rate of tax on dividends equal to 15% of the dividend, provided that such holder (i) qualifies for benefits under the Treaty, (ii) holds, directly and indirectly, less than 10% of Bluehill ID s voting stock, and (iii) does not conduct business through a permanent establishment or fixed base in Switzerland to which the shares are attributable. Such an eligible holder must apply for a refund of the amount of the Withholding Tax in excess of the 15% Treaty rate. A Non-resident Holder who is a resident of the United States for purposes of the Treaty is eligible for a reduced rate of tax on dividends equal to 5% of the dividend, provided that such holder (i) is a company, (ii) qualifies for benefits under the Treaty, (iii) holds directly more than 10% of Bluehill ID s voting stock, and (iv) does not conduct business through a permanent establishment or fixed place of business in Switzerland to which the shares are attributable. Such an eligible holder must apply for a refund of the amount of the Withholding Tax in excess of the 5% Treaty rate. Claims for refunds must be filed on Swiss Tax Form 82 (82C for corporations; 82I for individuals; 82E for other entities), which may be obtained from any Swiss Consulate General in the United States or from the Federal Tax Administration of Switzerland at the address below, together with an instruction form. Four copies of the form must be duly completed, signed before a notary public of the United States, and sent to the Federal Tax Administration of Switzerland, Eigerstrasse 65, CH-3003 Berne, Switzerland. The form must be accompanied by suitable evidence of deduction of Swiss tax withheld at source, such as certificates of deduction, signed bank vouchers or credit slips. The form may be filed on or after July 1 or January 1 following the date the dividend was payable, but no later than December 31 of the third year following the calendar year in which the dividend became payable.

Stamp Duty upon Transfer of Securities

The sale of shares, whether by Swiss residents or Non-resident Holders, may be subject to federal securities transfer Stamp Duty of 0.15%, calculated on the sale proceeds, if the sale occurs through or with a Swiss bank or other Swiss securities dealer, as defined in the Swiss Federal Stamp Duty Act. The Stamp Duty has to be paid by the securities dealer and may be charged to the parties in a taxable transaction who are not securities dealers.

BLUEHILL ID SHAREHOLDERS ARE URGED TO CONSULT THEIR OWN TAX ADVISORS AS TO SPECIFIC TAX CONSEQUENCES TO THEM OF THE OFFER, INCLUDING THE APPLICABILITY AND EFFECT OF ANY STATE, LOCAL OR FOREIGN TAX LAWS AND OF CHANGES IN APPLICABLE TAX LAWS.

COMPARISON OF SCM MICROSYSTEMS STOCKHOLDERS AND BLUEHILL ID SHAREHOLDERS RIGHTS AND CORPORATE GOVERNANCE MATTERS

This section of the proxy statement and prospectus describes the material differences between the rights of SCM s and Bluehill ID s respective stockholders and shareholders. While SCM believes that the description summarizes the material differences between the two, this summary may not contain all of the information that is important to you. You should carefully read this entire document and the other documents referred to for a more complete understanding of the differences among the rights of SCM s stockholders and Bluehill ID s shareholders.

The rights of Bluehill ID shareholders are governed by the Swiss Code of Obligations and Bluehill ID s articles of incorporation (*Statuten*), as amended. The rights and obligations of the board of directors and the management of Bluehill ID are further governed by the bylaws (*Organisationsreglement*) of Bluehill ID. These documents are referred to as the articles of incorporation and bylaws of Bluehill ID, respectively. In the table below summarizing the material differences between the rights of SCM s stockholders and Bluehill ID s shareholders, Swiss legal concepts are expressed in English terms and not in their original language. These concepts may not be identical to the concepts described by the same English terms as they exist under the laws of other jurisdictions.

The rights of SCM stockholders are currently governed by the Delaware General Corporation Law, the Fourth Amended and Restated Certificate of Incorporation, and the amended and restated bylaws of SCM, which are referred to as the certificate of incorporation and bylaws of SCM, respectively. Upon acceptance of the public share-for-share offer, Bluehill ID shareholders who have tendered their bearer shares in Bluehill ID will become stockholders of SCM, and their rights will be governed by the Delaware General Corporation Law, and the certificate of incorporation and bylaws of SCM.

This summary does not include a complete description of all aspects in which Delaware corporate law and Swiss corporate law differ, all differences among the rights of SCM s stockholders and Bluehill ID s shareholders, nor does it include a complete description of the specific rights of these respective stockholders and shareholders. Furthermore, the identification of some of the differences in the rights of these stockholders and shareholders as material is not intended to indicate that other differences that may be equally important do not exist. You are urged to read carefully the governing documents of SCM and Bluehill ID. See the section entitled, Where You Can Find More Information for information on how you can request copies of these documents free of charge. Copies of the certificate of incorporation and bylaws of SCM are filed as exhibits to the reports of SCM filed with the Securities and Exchange Commission.

Although it is impracticable to compare all aspects in which Delaware corporate law and Swiss corporate law, and SCM s and Bluehill ID s governing documents, differ with respect to rights of SCM s stockholders and Bluehill ID s shareholders, the following is a brief discussion summarizing certain differences between them.

	SCM Stockholder Rights	**Bluehill ID Shareholder Rights**
Authorized Capital Stock	The authorized capital stock of SCM currently consists of 40,000,000 shares of SCM common stock, par value $0.001 per share, and 10,000,000 shares of preferred stock, par value $0.001 per share. All of the SCM preferred shares	Bluehill ID s share capital currently amounts to CHF 32,023,797 consisting of 32,023,797 bearer shares with a nominal value of CHF 1.00 each.

	are available for future issuance in one or more series to be issued from time to time. At SCM s 2009 Annual Meeting of its Stockholders, which is being held on October 29, 2009, SCM s stockholders are voting upon a proposal to increase the number of shares of SCM common stock authorized for issuance by 20,000,000 shares, to an aggregate of 60,000,000 shares.	The articles of incorporation of Bluehill AD provide that the board of directors of Bluehill ID is authorized, at any time until 25 May 2011, to increase in one or more series the share capital up to a maximum aggregate amount of CHF 9,624,898.00 through the issuance of a maximum of 9,624,898.00 bearer shares, which shall be fully paid-in, with a par value of CHF 1.00 per share; provided that the board of directors is authorized to exclude the rights of the shareholders to subscribe shares in priority, provided that such authorized share capital is used

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
		for financing of the acquisition of enterprises, divisions thereof, participations or newly-planned investments.
		In addition, the articles of incorporation of Bluehill ID provide for a conditional share capital (*bedingtes Aktienkapital*) in the maximum of CHF 9,882,898.00 through the issuance of a maximum of 9,882,898 bearer shares with a nominal value of CHF 1.00 each by the exercise of conversion and/or option rights which are granted in connection with bond issues or similar obligations of Bluehill ID; provided, however, that the pre-emptive subscription rights of the Bluehill ID shareholders have been withdrawn with regard to 3,914,790 bearer shares in favor of BH Capital Management AG.
		Finally, the articles of incorporation of Bluehill ID provide for a conditional share capital *(bedingtes Aktienkapital)* in the maximum of CHF 4,000,000.00 through the issuance of a maximum of 4,000,000 bearer shares with a nominal value of CHF 1.00 each by the exercise of option rights which the employees of Bluehill ID and its Bluehill ID Group Companies are granted. The pre-emptive subscription rights of the Bluehill ID shareholders is withdrawn.
Preferred Stock	SCM s board of directors is authorized to fix or alter the rights, preferences, privileges, and restrictions granted to or imposed upon wholly unissued series of preferred stock. There are currently no outstanding shares of preferred stock.	The articles of incorporation of Bluehill ID currently do not provide for preferred stock (*Vorzugsaktien*). The general meeting of shareholders of Bluehill ID could, however, introduce preferred stock by a resolution passed by a qualified majority of at least two- thirds of the votes represented and the absolute

		majority of the par value of shares represented.
Number of Directors	SCM s board of directors shall consist of that number of directors specified in the bylaws, the exact number to be fixed from time to time exclusively by a resolution adopted by a majority of the total number of authorized directors (whether or not any vacancies exist at the time any such resolution is presented to the board of directors for adoption).	Pursuant to the articles of incorporation of Bluehill ID, the board of directors shall consist of one or several members. The shareholders of Bluehill ID elect the members of the board of directors of Bluehill ID by a resolution adopted by a absolute majority of the votes represented at a general meeting of shareholders. The current number of directors registered with the

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	The current authorized number of directors is eight (8).	commercial register of the canton of St. Gallen is four (4).
Cumulative Voting	Under Delaware General Corporation Law, cumulative voting is permitted if provided for in the certificate of incorporation. SCM s certificate of incorporation does not provide for cumulative voting.	Under the Swiss Code of Obligations, cumulative voting (*Stimmrechtsaktien*) were permitted if provided for in the articles of incorporation. The articles of incorporation of Bluehill ID do not provide for cumulative voting.
Quorum	At any meeting of the stockholders, the holders of one-third (1/3) of all of the shares of the stock entitled to vote at the meeting, present in person or by proxy, shall constitute a quorum for all purposes, unless or except to the extent that the presence of a larger number may be required by law. If a notice of any adjourned special meeting of stockholders is sent to all stockholders entitled to vote thereat, stating that it will be held with those present constituting a quorum, then except as otherwise required by law, those present at such adjourned meeting shall constitute a quorum, and all matters shall be determined by a majority of the votes cast at such meeting.	The general meeting of shareholders carries out its elections and passes its resolutions with the absolute majority of the share votes represented, either in person or by proxy, unless or except to the extent mandatory law or the articles of incorporation provide otherwise. Each share entitles to one vote. The Swiss Code of Obligation as well as the Swiss merger act provide for some resolutions of the general meeting of shareholders that need to be passed by a qualified majority of at least two-thirds of the votes represented and the absolute majority of the par value of shares represented. There is currently no special quorum in the articles of incorporation of Bluehill ID deviating from applicable Swiss law.
Voting Stock	Each stockholder has one vote for every share of stock entitled to vote. Currently, there are no shares of any class outstanding other than SCM common stock.	Each share entitles to one vote at the general meeting of shareholders. Bluehill ID s articles of incorporation do currently not provide for the issuance of shares with cumulative voting or privileged voting rights.
Classification of Board of Directors	SCM s articles of incorporation provide that the directors be divided into three classes, as nearly equal in number as possible, designated as Class I, Class II, and Class III. Each class is elected every three years.	Bluehill ID s articles of incorporation and bylaws do not provide for classification of Bluehill ID s members of the board of directors. Each member of the board is elected for a term of six years and is, in principle, reeligible.

Removal of Directors	Subject to the rights of holders of any series of preferred stock then outstanding, any director, or the entire board of directors, may be removed from office at any time, with or without cause, but only by the affirmative vote of the holders of at least a majority of the voting power of all of the then outstanding shares of capital stock of SCM entitled to vote generally in the election of directors, voting together as a single class. Vacancies resulting from such removal may be filled	The general meeting of shareholders is entitled to remove the entire board of directors or any individual member at any time and without cause by a resolution with the absolute majority of the share votes represented, either in person or by proxy at any general ordinary or extraordinary meeting of shareholders.

	SCM Stockholder Rights	**Bluehill ID Shareholder Rights**
	by a majority of the directors then in office, though less than a quorum, or by the stockholders at a special meeting held for that purpose. Directors so chosen shall hold office until the next annual meeting of stockholders.	
Vacancies on the Board of Directors	Vacancies on the board of directors for any reason and newly created directorships resulting from an increase in the authorized number of directors may be filled only by vote of a majority of the remaining members of SCM s board of directors, although less than a quorum, at any meeting of the board of directors. A person so elected by the board of directors to fill a vacancy or newly created directorship shall hold office until the next election of the Class for which such director shall have been chosen and until his or her successor shall have been duly elected and qualified.	Vacancies on the board of directors for any reason may be filled only by a resolution with the absolute majority of the share votes represented, either in person or by proxy at any general or extraordinary meeting of shareholders.
Stockholder and Shareholder Action by Written Consent	SCM s certificate of incorporation prohibits the taking of any action by written consent of the stockholders in lieu of a meeting.	The shareholders carry out elections and pass resolutions at the general ordinary or extraordinary meetings of shareholders either in person or by proxy. Shareholder resolutions by written consent in lieu of a meeting is not established for corporations in the Swiss Code of Obligations.
Amendment of the Articles or Certificate of Incorporation	SCM reserves the right to amend, alter, change or repeal any provision contained in the certificate of incorporation.	The general meeting of shareholders has the inalienable power to amend Bluehill ID s articles of incorporation. The amendment of the articles of incorporation requires a resolution with the absolute majority of the share votes represented, either in person or by proxy. A resolution of the general meeting of shareholders passed by a qualified majority of at least two- thirds of the votes represented and the absolute majority of the par value of shares

		represented shall be required for important amendments of the articles of incorporation, such as the change of the company purpose or increases of the authorized or conditional share capital.
Amendment of Bylaws	SCM s certificate of incorporation confers the power to adopt, amend, or repeal the bylaws upon the board of directors and the stockholders. Any adoption, amendment, or repeal of the bylaws by the board of directors requires	Since under Swiss law the bylaws govern only the rights and obligations of the board of directors and the management, Bluehill ID s articles of incorporation confer the power to adopt the bylaws upon the board of

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	the approval of a majority of the total number of authorized directors. Any adoption, amendment, or repeal of the bylaws by the stockholders requires the approval of at least two-thirds of the capital stock entitled to vote generally in the election of directors, voting together as a single class.	directors. According to the current bylaws, any resolution on the adoption of the bylaws requires the presence of a majority of two-thirds of the members of the board of directors. The adoption of the bylaws requires the approval of a majority of two-thirds of the members present.
Annual Meeting of Stockholders or Shareholders	An annual meeting of the stockholders, for the election of directors to succeed those whose terms expire and for the transaction of such other business as may properly come before the meeting, shall be held at such place, on such date, and at such time as the board of directors shall each year fix, which date shall be within thirteen months subsequent to the later of the date of incorporation or the last annual meeting of stockholders.	Annual shareholders meetings shall be held at such place, on such date, and at such time as the board of directors shall each year fix, which date shall within six months upon the close of the business year.
Special Meeting of Stockholders or Shareholders	SCM s bylaws provide that special meetings of stockholders may be called by the board of directors pursuant to a resolution adopted by a majority of the total number of authorized directors (whether or not any vacancies exist), or by the holders of not less than 10% of all shares entitled to cast votes at the meeting, voting together as a single class and shall be held at such place, on such date, and at such time as they shall fix.	Special or extraordinary meetings of shareholders may be called pursuant to a resolution adopted by the board of directors. Shareholders meetings may also be called by the auditors and, as the case may be, by the liquidator and bondholder trustees. The calling of a general meeting of shareholders may also be requested by one or more shareholders representing together at least 10% of the share capital or shares whose nominal value amount in total to at least CHF 1,000,000.
Notice of Stockholder or Shareholder Meeting	Written notice of the place, date, and time of all meetings of the stockholders shall be given, not less than ten (10), nor more than sixty (60) days before the date on which the meeting is to be held, to each stockholder entitled to vote at such meeting, except as otherwise provided in SCM s bylaws or required by law (meaning, here and hereinafter, as required from time to time by the	The calling of the general shareholders meeting shall be made not less than twenty (20) days before the day of the meeting through publication in the Swiss Official Commercial Gazette of Commerce or by registered letter to the shareholders, to the extent the addresses of all shareholders are known.

Delaware General Corporation Law or the certificate of incorporation of SCM).

When a meeting is adjourned to another place, date or time, written notice need not be given of the adjourned meeting if the place, date and time thereof are announced at the meeting at which the adjournment is taken; provided, however, that if the date of any adjourned meeting is more than thirty

	SCM Stockholder Rights	**Bluehill ID Shareholder Rights**
	(30) days after the date for which the meeting was originally noticed, or if a new record date is fixed for the adjourned meeting, written notice of the place, date, and time of the adjourned meeting shall be given in conformity herewith. At any adjourned meeting, any business may be transacted which might have been transacted at the original meeting.	
Conduct of Stockholder or Shareholder Meeting	At an annual or special meeting of the stockholders, only such business shall be conducted as shall have been properly brought before the meeting. To be properly brought before a meeting, business must be (a) specified in the notice of meeting (or any supplement thereto) given by or at the direction of the board of directors, (b) properly brought before the meeting by or at the direction of the board of directors, (c) properly brought before an annual meeting by a stockholder, or (d) properly brought before a special meeting by a stockholder, but if, and only if, the notice of a special meeting provides for business to be brought before the meeting by stockholders.	No resolutions can be passed on motions concerning agenda items which have not been duly announced, except concerning a request for the convening of an extraordinary general meeting of shareholders, the conduct of a special investigation or a universal meeting (as long as the owners or representatives of all shares are present, all subjects pertaining to the area of business of the general meeting of shareholders may be discussed and valid resolutions may be passed). To be properly brought before a meeting, the calling must contain, besides day, time and place of the meeting, the items on the agenda as well as the motions of the board of directors and the shareholders who requested the holding of a meeting of shareholders or the inclusion of an item in the agenda. The owners, beneficiaries or representatives of all shares may, provided that there is no objection, hold a general meeting of shareholders without observing the foregoing formalities for the convening of the general meeting of shareholders.
Delivery and Notice Requirements of Stockholder or Shareholder Nominations and Proposals	For business to be properly brought before a meeting by a stockholder, the stockholder must have given timely notice thereof in writing to the Secretary of SCM. To be timely, a stockholder proposal to be presented at an annual	Shareholder nominations and proposals to the agenda must be received by Bluehill ID s board of directors prior to the start of the notice period for the calling of the general shareholders meeting. Bluehill ID s articles of

	meeting shall be received at SCM s principal executive offices not less than 120 calendar days in advance of the date that SCM s (or its predecessor s) proxy statement was released to stockholders in connection with the previous year s annual meeting of stockholders, except that if no annual meeting was held in the previous year or the date of the annual meeting has been changed by more than 30 calendar	incorporation do not provide for a deadline by which nominations or proposals to the agenda must be received by Bluehill ID.

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	days from the date contemplated at the time of the previous year s proxy statement, or in the event of a special meeting, notice by the stockholder to be timely must be received not later than the close of business on the tenth day following the day on which such notice of the date of the meeting was mailed or such public disclosure was made. A stockholder s notice to the Secretary shall set forth as to each matter the stockholder proposes to bring before the annual or special meeting (a) a brief description of the business desired to be brought before the annual or special meeting and the reasons for conducting such business at the special meeting, (b) the name and address, as they appear on SCM s books, of the stockholder proposing such business, (c) the class and number of shares of SCM which are beneficially owned by the stockholder, and (d) any material interest of the stockholder in such business.	
Record Date	Unless otherwise approved by the Chairman, attendance at the stockholders meeting is restricted to stockholders of record, persons authorized in accordance with the bylaws to act by proxy, and officers of SCM. The board of directors may fix a record date, which shall not be more than sixty (60) nor fewer than ten (10) days before the date of any meeting of stockholders, as of which there shall be determined the stockholders who are entitled: to notice of or to vote at any meeting of stockholders or any adjournment thereof.	Neither Bluehill ID s articles of incorporation or the Swiss Code of Obligations provides for a record date. A record date, if any, may be fixed by the board of directors. The Swiss Code of Best Practice recommends that a record date, as of which the shareholders shall be entitled to participate in the general meeting of shareholders, should be not more than a few days before the date of the meeting.
Declaration and Payment of Dividends	The bylaws of SCM provide that, subject to applicable law, the board of directors may declare dividends from time to time.	The Swiss Code of Obligations provides that the general meeting of shareholders has the inalienable power to resolve on the declaration of the dividends.

Indemnification of Directors and Officers; Advancement of Expenses	The certificate of incorporation of SCM provides for the indemnification of current and former directors, officers, and employees of SCM, to the fullest extent authorized by Delaware law. SCM s certificate of incorporation provides that SCM may advance expenses to directors and officers upon	Bluehill ID s articles of incorporation and bylaws do not contain any provisions as to indemnification.

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	receipt of an undertaking by or on behalf of such director or officer to repay an amount so advanced if it should be determined ultimately that such director or officer is not entitled to be indemnified under the certificate of incorporation or otherwise.	
Interested Party Transactions	Any merger or combination between SCM and an entity or person owning, directly or indirectly, 10% or more of the shares of SCM common stock (an Interested Purchaser) and any sale of SCM or sale of all or substantially all of the assets of SCM to an Interested Purchaser requires the affirmative vote of at least two-thirds of the combined voting power of all of the then-outstanding shares of SCM entitled to vote unless certain conditions are met, which include that SCM s board of directors approved such transaction by two-thirds.	
Stockholder or Shareholder Rights Plan	SCM and American Stock Transfer & Trust Company (the rights agent) entered into a Rights Agreement, dated as of November 8, 2002, as amended December 10, 2008, pursuant to which each common stockholder received a dividend of one preferred share purchase right to purchase one one- thousandth of a share of SCM s series A participating preferred stock for each outstanding share of SCM common stock held as of the record date. The rights become exercisable if a person or group acquires 15% or more of the outstanding SCM common stock, or announces a tender or exchange offer the consummation of which would result in ownership by a group or person of 15% or more of the then outstanding SCM common stock.	Bluehill ID is not a party to any shareholder rights plan.

The Rights Agreement is expected to be amended prior to the closing of the Offer to provide that the issuance of the shares of SCM common stock to the Bluehill ID shareholders that tender their bearer shares in Bluehill ID will not cause: (i) the rights to purchase series A participating preferred stock pursuant to the rights agreement to become exercisable under the rights agreement; (ii) Bluehill ID or any of its affiliates to be deemed an Acquiring Person (as

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	that term is used in the rights agreement); or (iii) a Triggering Event, the Distribution Date or the Shares Acquisition Date (as such terms are defined in the Rights Agreement) to occur.	
Anti-Takeover Provisions	Certain provisions of SCM s certificate of incorporation, bylaws, and the Delaware General Corporation Law may be deemed to have an anti-takeover effect. Such provisions may delay, deter or prevent a tender offer or takeover attempt that a stockholder might consider to be in that stockholder s best interests, including attempts that might result in a premium over the market price for the shares held by stockholders. SCM s board of directors may issue additional shares of SCM common stock or establish one or more classes or series of preferred stock, having the number of shares (up to 10,000,000), designations, relative voting rights, dividend rates, liquidation and other rights, preferences and limitations as determined by SCM s board of directors without stockholder approval. SCM s certificate of incorporation and bylaws also contain a number of provisions that could impede a takeover or change in control of SCM, including but not limited to the elimination of stockholders ability to take action by written consent without a meeting and the elimination of cumulative voting in the election of directors. In addition, SCM is subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law. In general, the statute prohibits a publicly-held Delaware corporation from	Bluehill ID s articles of incorporation do not contain any anti-takeover provisions. The provisions of the Swiss Federal Act on Cartels and other Restraints remain reserved.

engaging in a business combination with an interested stockholder for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner.

In connection with its listing on the regulated market (Prime Standard) of

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	the Frankfurt Stock Exchange, SCM is required to comply with the German Takeover Act *(wertpapiererwerbs-und übernahmegesetz).* Among other things, the German Takeover Act regulates public offers, and requires companies seeking to make a public offer to inform the BaFin and the public of the offer, to provide certain disclosure to the target s stockholders, to generally treat stockholders equally in an offer, and to comply with certain other regulatory requirements. In addition, the German Takeover Act gives broad authority to the BaFin to interpret the German Takeover Act and to review and regulate specific public offers. Compliance with the German Takeover Act could have the effect of delaying, deferring or preventing a tender offer or takeover attempt that a stockholder might consider to be in that stockholder s best interests, including attempts that might result in a premium over the market price for the shares held by stockholders. Each of the foregoing may have the effect of preventing or rendering more difficult or costly, the completion of a takeover transaction that stockholders might view as being in their best interests.	
Stock Trading Policy	SCM s insider trading policies forbid insider trading. If you will be an employee of SCM or Bluehill ID after the closing of the Offer, your shares may be subject to these insider trading policies.	Bluehill ID s articles of incorporation do not contain any provisions as to insider trading. Bluehill ID s insider trading policy forbids insider trading.
Stockholders and Shareholders Disclosure Obligations; Publication and Notification Requirements	The shares of SCM common stock have been admitted to the regulated market *(Regulierter Markt)* as well as on the sub-segment of the regulated market of the Frankfurt Stock Exchange with	Under the rules and regulations for the over-the-counter market of Deutsche Boerse AG Bluehill ID has no continuing disclosure obligations.

additional post-admission obligations (Prime Standard). SCM is an issuer whose home country, as defined in the German Securities Trading Act *(Wertpapierhandelsgesetz)*, is the Federal Republic of Germany, and is therefore subject to the provisions relating to the notification of shareholdings of the German Securities Trading Act. This Act provides that each person whose voting rights, through the

	SCM Stockholder Rights	Bluehill ID Shareholder Rights
	purchase or sale of securities or otherwise, reach, exceed or, after exceeding, fall below the 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% voting rights thresholds in a listed company must notify the company and the BaFin in writing and without delay, but at the latest within four trading days after they have reached, exceeded or fallen below such threshold. Such notice must state that such person has reached, exceeded or fallen below such threshold and specify the total number of votes to which such person is entitled. The company is required to publish such notification in several media (inter alia newspapers, news agencies and the Internet), including such media which provide for a pan-European and national publication, without undue delay and in any event within three trading days following the receipt of the notification. Subsequently, the company is required to transmit the notification without undue delay to the companies register *(Unternehmensregister)*.	

THE SCM SPECIAL MEETING OF STOCKHOLDERS

General

SCM is sending you this proxy statement and prospectus as part of the solicitation of proxies by SCM s board of directors for use at SCM s special meeting of stockholders and any adjournments or postponements of the meeting. SCM is first mailing this proxy statement and prospectus, including a notice of the SCM special meeting of stockholders and a form of proxy on or about [ ].

Date, Time and Place of the SCM Special Meeting

The SCM special meeting is scheduled to be held on:

[ ], 2009 at [ ], local time
at SCM s United States Office
1900 Carnegie Avenue, Building B
Santa Ana, California 92705
+1-949-250 8888 Ext. 106

Purpose of the SCM Special Meeting

At the SCM special meeting SCM stockholders will be asked to:

1. consider and vote upon a proposal to approve the Offer and, specifically, the issuance of new shares of SCM common stock in connection with the Offer to effect the business combination proposed under the Business Combination Agreement; and

2. consider and vote upon any motion to adjourn or postpone the SCM special meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve the proposal described immediately above.

SCM S BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR EACH OF PROPOSALS NO. 1 AND 2.

Proposals to be Voted on at the SCM Special Meeting

Proposal No. 1: The Business Combination and Offer Proposal

To consider and vote upon a proposal to approve the Offer and, specifically, the issuance of new shares of SCM common stock in connection with the Offer to effect the business combination proposed under the Business Combination Agreement, a copy of which is attached as *Annex A*.

Under NASDAQ Marketplace Rule 4350(i), a company listed on NASDAQ is required to obtain stockholder approval prior to the issuance of common stock, among other things, in connection with the acquisition of another company s stock, if the number of shares of common stock to be issued is in excess of 20% of the number of shares of common stock then outstanding. The newly issued shares of SCM common stock to be issued in the business combination are expected to exceed the 20% threshold under the NASDAQ Marketplace Rules. Accordingly, in order to ensure compliance with NASDAQ Marketplace Rule 4350(i), SCM must obtain the approval of SCM stockholders for the issuance of these securities in the transaction.

SCM S BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR PROPOSAL NO. 1.

Proposal No. 2: Adjournment

To consider and vote upon a motion to adjourn or postpone the SCM special meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve Proposal No. 1.

SCM S BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR PROPOSAL NO. 2.

Required Vote for Approval of Proposal 1 and Proposal 2

Approving Proposal 1 and Proposal 2 requires the affirmative vote of a majority of the shares of SCM common stock present in person or represented by proxy and entitled to vote at the special meeting at which a quorum is present. Each stockholder of record on the SCM record date will be entitled to one vote per share of SCM common stock held on the SCM record date on all matters submitted for consideration of, and to be voted upon by, the stockholders at the special meeting.

Each of Lincoln Vale, which beneficially owns approximately 6.1% of the outstanding shares of SCM common stock as of September 30, 2009 and approximately 9.8% of the outstanding bearer shares in Bluehill ID as of October 1, 2009, and Bluehill ID, which, collectively with Ayman Ashour, Bluehill ID s Chief Executive Officer and President of the board of directors, beneficially owns approximately 5.2% of the outstanding shares of SCM common stock as of September 30, 2009, will have the right to vote at the SCM special meeting.

Record Date; SCM Stockholders Entitled to Vote

SCM s board of directors has fixed [ ] 2009 as the record date for the SCM special meeting. Only stockholders of record at the close of business on that date will receive notice of and be able to vote at the SCM special meeting. At the close of business on the record date, there were [ ] shares of SCM common stock outstanding held by approximately [ ] record holders.

As of the record date, the directors and executive officers of SCM beneficially owned approximately [ ] shares of SCM common stock, entitling them to exercise approximately [ ]% of the voting power of the SCM common stock.

Quorum

The required quorum for the approval of Proposal 1 and Proposal 2 is one-third (1/3) of the shares of SCM common stock issued and outstanding as of the SCM record date. Shares voted FOR, AGAINST or WITHHELD from a matter voted upon by the stockholders at the special meeting will be treated as being present at the special meeting for purposes of establishing a quorum for the transaction of business, and will also be treated as shares represented and voting at the special meeting (the Votes Cast) with respect to any such matter.

Proxies; Abstentions and Broker Non-Votes

You should complete and return the accompanying proxy card or vote your proxy by telephone or the Internet, whether or not you plan to attend the SCM special meeting in person. All properly executed proxies received by SCM before the SCM special meeting that are not revoked will be voted at the SCM special meeting in accordance with the instructions indicated on the proxies or, if no direction is indicated, FOR approval of the Proposals. Properly executed proxies, other than proxies voting against Proposal 2, also will be voted for any adjournment or postponement of the SCM special meeting for the purpose of soliciting additional votes to approve Proposal 1, if necessary.

Properly executed proxies marked Abstain will not be voted at the SCM special meeting. Abstentions will be counted for purposes of determining both (i) the presence or absence of the quorum for the approval of the Proposals, and (ii) the total number of Votes Cast with respect to a proposal. Accordingly, abstentions will have the same effect as a vote against a proposal submitted for consideration of the stockholders.

If your shares of SCM common stock are held in street name by your broker, you must follow the directions your broker provides to you regarding how to instruct your broker to vote your shares of SCM common stock. You cannot vote shares of SCM common stock held in street name by returning a proxy card to SCM. In addition, a broker cannot vote shares of SCM common stock it holds in street name for the beneficial owners without specific instructions from the beneficial owner. Broker non-votes will be counted for purposes of determining the presence or absence of a quorum for the approval of the Proposals, but will not be counted for purposes of determining the number of Votes Cast with respect to a proposal. Broker non-votes include shares for which a bank, broker or other nominee holder has not received voting instructions from the beneficial owner and for which the nominee holder does not have discretionary power to vote on a particular matter.

SCM s board of directors is not currently aware of any business to be brought before the special meeting other than the Proposals. However, if any other matters are properly brought before the special meeting, the proxies named in the proxy card will have discretion to vote the shares represented by duly executed proxies in their sole discretion.

SCM s board of directors urges you to complete, date and sign the accompanying proxy card and return it promptly in the enclosed, pre-paid envelope or to alternatively vote your proxy via the telephone or Internet voting instructions on your card. If your shares of SCM common stock are held in street name by your broker, you must follow the directions your broker provides to you regarding how to instruct your broker to vote your shares of SCM common stock. You cannot vote shares of SCM common stock held in street name by returning a proxy card to SCM.

Voting and Revocation of Proxies

Voting by Mail

By signing and returning the proxy card in the enclosed prepaid and addressed envelope, you are authorizing individuals named on the proxy card (each, a proxy) to vote your shares at the meeting in the manner you indicate. SCM encourages you to sign and return the proxy card even if you plan to attend the meeting. In this way, your shares will be voted if you are unable to attend the meeting. If you received more than one proxy card, it is an indication that your shares are held in multiple accounts. Please sign and return all proxy cards to ensure that all of your shares are voted.

Voting by Telephone

To vote by telephone, please follow the instructions included with your proxy card. If you vote by telephone, you do not need to complete and mail your proxy card.

Voting over the Internet

To vote over the Internet, please follow the instructions included with your proxy card. If you vote over the Internet, you do not need to complete and mail your proxy card.

Voting in Person

If you plan to attend the meeting and vote in person, SCM will provide you with a ballot at the meeting. If your shares are registered directly in your name, that is, you hold a share certificate, you are considered the shareholder of record and you have the right to vote in person at the meeting. If your shares are held in the name of your broker or other nominee, you are considered the beneficial owner of shares held in street name. As a beneficial owner, if you wish to vote at the meeting, you will need to bring with you to the meeting a legal proxy from your broker or other nominee authorizing you to vote such shares. Contact your broker or other record holder of the shares for assistance if this applies to you.

Your grant of a proxy on the enclosed proxy card does not prevent you from voting in person or otherwise revoking your proxy at any time before it is voted at the SCM special meeting. To revoke your proxy, either:

Deliver a signed notice of revocation or a properly executed new proxy card bearing a later date to:

In the United States:

SCM Microsystems, Inc.
1900-B Carnegie Ave.
Santa Ana, CA 92705
+1-949-250-8888 Ext. 106
ir@scmmicro.com

In Europe:

SCM Microsystems GmbH
Oskar-Messter-Straße 13
85737 Ismaning, Germany
+49 89 9595-5000
ir@scmmicro.com

Attend the SCM special meeting and vote your shares in person.

Attendance at the SCM special meeting will not, in and of itself, have the effect of revoking your proxy.

Solicitation of Proxies and Expenses

The cost of soliciting proxies will be borne by SCM. SCM may reimburse brokerage firms, banks and other persons representing the beneficial owners of shares for their expenses in forwarding solicitation materials to such beneficial owners. Solicitation of proxies by mail may be supplemented by telephone, telegram, facsimile or personal solicitation by SCM directors, officers or regular employees without additional compensation.

WHERE YOU CAN FIND MORE INFORMATION

SCM Microsystems, Inc.

SCM files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. You may read and copy these reports, statements or other information filed by SCM at the Securities and Exchange Commission s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information regarding the public reference rooms. The Securities and Exchange Commission filings of SCM are also available to the public from commercial document retrieval services and at the website maintained by the Securities and Exchange Commission at *http://www.sec.gov*. SCM stockholders may request a copy of such documents in writing or by calling SCM at +1-949 250-8888 Ext. 106, emailing SCM at ir@scmmicro.com or writing to SCM Microsystems, Inc., 1900 Carnegie Avenue, Building B, Santa Ana, California 92705, Attention: Investor Relations.

SCM is filing this proxy statement as part of a Registration Statement on Form S-4 regarding the business combination with Bluehill ID. This proxy statement and prospectus constitutes a prospectus of SCM, in addition to being a proxy statement of SCM. The Registration Statement, including the attached annexes, exhibits and schedules, contains additional relevant information about SCM, SCM common stock and Bluehill ID. Stockholders are urged to read the proxy statement and prospectus because it will contain important information about SCM and Bluehill ID and the proposed transaction. As allowed by the Securities and Exchange Commission rules, this proxy statement and prospectus does not contain all the information you can find in the Registration Statement on Form S-4 or the exhibits to the Registration Statement.

SCM incorporates by reference (i) the Business Combination Agreement, a copy of which is attached to this proxy statement and prospectus as *Annex A*, and (ii) the Written Opinion of Jupiter Capital Services GmbH, a copy of which is attached to this proxy statement and prospectus as *Annex B.* Documents incorporated by reference are available from SCM without charge, excluding any exhibits to those documents, unless the exhibit is specifically incorporated by reference in this proxy statement and prospectus. SCM stockholders may request a copy of such documents in writing or by calling SCM Microsystems at +1-949 250-8888 Ext. 106, emailing SCM at ir@scmmicro.com or writing to SCM Microsystems, Inc., 1900 Carnegie Avenue, Building B, Santa Ana, California 92705, Attention: Investor Relations.

SCM has supplied all information contained in this proxy statement and prospectus relating to SCM, and Bluehill ID has supplied all information contained in this proxy statement and prospectus relating to Bluehill ID. SCM is not incorporating the contents of its website, the website of Bluehill ID, the website of the Securities and Exchange Commission, or any other website into this proxy statement and prospectus.

IN ORDER FOR YOU TO RECEIVE TIMELY DELIVERY OF THE DOCUMENTS IN ADVANCE OF SCM S SPECIAL MEETING OF STOCKHOLDERS, SCM SHOULD RECEIVE YOUR REQUEST NO LATER THAN [ ], 2009.

Other Information

The proxy statement and prospectus will be mailed to stockholders of SCM. Stockholders may obtain a free copy of the definitive proxy statement and prospectus and other documents when filed with the Securities and Exchange Commission at the Securities and Exchange Commission s website at *http://www.sec.gov*. The proxy statement and prospectus and other relevant documents may also be obtained free of charge from SCM by calling SCM at +1-949

250-8888 Ext. 106, emailing SCM at ir@scmmicro.com or writing to SCM Microsystems, Inc., 1900 Carnegie Avenue, Building B, Santa Ana, California 92705, Attention: Investor Relations.

SCM has not authorized anyone to give any information or make any representation about the business combination or SCM or Bluehill ID that is different from, or in addition to, that contained in this proxy statement and prospectus. Therefore, if anyone does give you information of this kind, you should not rely on it. If you are in a jurisdiction where offers to exchange or sell, or solicitations of offers to exchange or purchase, the securities offered by this proxy statement or prospectus or the solicitation of proxies is unlawful, or if you are a person to whom it is unlawful to direct these types of activities, then the offer presented in this proxy statement and prospectus does not extend to you. The information contained in this proxy statement and prospectus is accurate only as of the date of this proxy statement and prospectus unless the information specifically indicates that another date applies.

Important Notice Regarding the Availability of Proxy Materials for the SCM Stockholder Meeting to Be Held on [   ], 2009.

The proxy statement and prospectus is available at www.scmmicro.com.

LEGAL MATTERS

Gibson, Dunn & Crutcher LLP, San Francisco, California, will pass upon the validity of the shares of SCM common stock offered by this proxy statement and prospectus.

EXPERTS

The financial statements of SCM Microsystems, Inc. as of and for the years ended December 31, 2008, 2007 and 2006 and the related financial statement schedule included in this proxy statement and prospectus have been audited by Deloitte & Touche GmbH, an independent registered public accounting firm, as stated in their reports and are included in reliance upon the reports of such firm given upon their authority as experts in accounting and auditing.

The financial statements of Hirsch Electronics Corporation as of and for the years ended November 30, 2008 and 2007 included in this proxy statement and prospectus have been audited by Squar, Milner, Peterson, Miranda & Williamson, LLP, independent auditors, as stated in their report, which is included elsewhere in this proxy statement and prospectus, and have been so included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The financial statements of Bluehill ID AG as of and for the years ended December 31, 2008 and 2007, and as of and for the six months ended June 30, 2009, included in this proxy statement and prospectus, have been prepared in accordance with International Financial Reporting Standards (as adopted by the International Accounting Standards Board).

Table of Contents

SCM MICROSYSTEMS, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Report of Independent Registered Public Accounting Firm	F-2
Audited Financial Statements:	
Consolidated Balance Sheets as of December 31, 2008 and 2007	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2008, 2007 and 2006	F-4
Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss) for the Years Ended December 31, 2008, 2007 and 2006	F-5
Consolidated Statements of Cash Flows for the Years Ended December 31, 2008, 2007 and 2006	F-6
Notes to Consolidated Financial Statements	F-7
Unaudited Financial Statements:	
Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2009 and 2008	F-31
Condensed Consolidated Balance Sheets as of June 30, 2009 and December 31, 2008	F-32
Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2009 and 2008	F-33
Notes to Consolidated Financial Statements	F-34

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, 2008 and 2007, 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, 2008. 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. SCM 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, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, 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 31, 2009

Table of Contents

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31, 2008	December 31, 2007
	(In thousands; except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 20,550	$ 18,600
Short-term investments		13,844
Accounts receivable, net of allowances of $689 and $341 as of December 31, 2008 and 2007, respectively	8,665	8,638
Inventories	5,065	2,738
Other current assets	1,139	1,455
Total current assets	35,419	45,275
Equity investments	2,244	
Property and equipment, net	1,236	1,522
Intangible assets, net	307	
Other assets	1,932	1,767
Total assets	$ 41,138	$ 48,564
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,555	$ 3,063
Accrued compensation and related benefits	1,763	1,213
Accrued restructuring and other charges	1,576	2,960
Accrued professional fees	1,419	993
Accrued royalties	475	417
Accrued sales tax related expenses	330	349
Other accrued expenses	1,959	1,976
Income taxes payable	411	277
Total current liabilities	11,488	11,248
Deferred tax liability	1,340	77
Long-term income taxes payable	184	200
Total liabilities	13,012	11,525
Commitments and contingencies (see Notes 12 and 14)		
Stockholders equity:		
	16	16

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 December 31, 2008 and 2007, respectively		
Additional paid-in capital	229,788	229,414
Treasury stock, 618 shares	(2,777)	(2,777)
Accumulated deficit	(202,199)	(192,089)
Accumulated other comprehensive income	3,298	2,475
Total stockholders equity	28,126	37,039
Total liabilities and stockholders equity	$ 41,138	$ 48,564

See notes to consolidated financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2008	2007	2006
	(In thousands, except per share data)		
Net revenue	$ 28,362	$ 30,435	$ 33,613
Cost of revenue	15,817	17,781	21,756
Gross profit	12,545	12,654	11,857
Operating expenses:			
Research and development	3,902	3,123	3,767
Selling and marketing	9,620	6,603	7,498
General and administrative	8,075	7,132	7,548
Amortization of intangibles		272	666
Restructuring and other charges (credits)		(4)	1,120
Gain on sale of assets	(1,455)		
Total operating expenses	20,142	17,126	20,599
Loss from operations	(7,597)	(4,472)	(8,742)
Loss on equity investments	(256)		
Interest income	757	1,639	1,350
Foreign currency losses and other income (expense), net	(2,638)	(346)	(225)
Loss from continuing operations before income taxes	(9,734)	(3,179)	(7,617)
Provision for income taxes	(752)	(113)	(73)
Loss from continuing operations	(10,486)	(3,292)	(7,690)
Gain (loss) from discontinued operations, net of income taxes	(213)	(215)	3,508
Gain on sale of discontinued operations, net of income taxes	589	1,586	5,224
Net income (loss)	$ (10,110)	$ (1,921)	$ 1,042
Basic and diluted loss per share from continuing operations	$ (0.66)	$ (0.21)	$ (0.49)
Basic and diluted income per share from discontinued operations	$ 0.02	$ 0.09	$ 0.56
Basic and diluted net income (loss) per share	$ (0.64)	$ (0.12)	$ 0.07
Shares used to compute basic and diluted income (loss) per share	15,743	15,725	15,638

See notes to consolidated financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)
Years Ended December 31, 2008, 2007 and 2006

	Common Stock		Additional Paid-in	Treasury	Accumulated	Other Cumulative Comprehensive Income	Total Stockholders	Comprehensive Income
	Shares	Amount	Capital	Stock	Deficit	(Loss)	Equity	(Loss)
					(In thousands)			
Balances, January 1, 2006	15,593	$ 16	$ 227,676	$ (2,777)	$ (192,756)	$ 458	$ 32,617	
Issuance of common stock upon exercise of options	26		72				72	
Issuance of common stock under Employee Stock Purchase Plan	79		190				190	
Stock-based compensation expense			642				642	
Unrealized gain on investments						71	71	$ 71
Foreign currency translation adjustment						684	684	684
Net income					1,042		1,042	1,042
Comprehensive income								$ 1,797
Balances, December 31, 2006	15,698	$ 16	$ 228,580	$ (2,777)	$ (191,714)	$ 1,213	$ 35,318	
Adjustment to Accumulated Deficit resulting from the adoption of FIN 48					1,546		1,546	
Issuance of common stock upon exercise of options	12		38				38	
Issuance of common stock under Employee Stock Purchase Plan	27		71				71	
Stock-based compensation expense			725				725	
Unrealized loss on investments						(14)	(14)	$ (14)
						1,276	1,276	1,276

Foreign currency translation adjustment								
Net loss					(1,921)		(1,921)	(1,921)
Comprehensive loss								$ (659)
Balances, December 31, 2007	15,737	$ 16	$ 229,414	$ (2,777)	$ (192,089)	$ 2,475	$ 37,039	
Issuance of common stock upon exercise of options	7		19				19	
Stock-based compensation expense			355				355	
Unrealized gain on investments						28	28	$ 28
Foreign currency translation adjustment						795	795	795
Net loss					(10,110)		(10,110)	(10,110)
Comprehensive loss								$ (9,287)
Balances, December 31, 2008	15,744	$ 16	$ 229,788	$ (2,777)	$ (202,199)	$ 3,298	$ 28,126	

See notes to consolidated financial statements.

Table of Contents

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2008	2007	2006
	(In thousands)		
Cash flows from operating activities:			
Net income (loss)	$ (10,110)	$ (1,921)	$ 1,042
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities from continuing operations:			
Gain from discontinued operations	(376)	(1,371)	(8,732)
Deferred income taxes	364	(26)	2
Depreciation and amortization	297	580	1,036
Stock-based compensation expense	355	725	632
Loss (gain) on sale of assets, net	(1,455)	(5)	46
Loss on equity investments	256		
Changes in operating assets and liabilities:			
Accounts receivable	(327)	(1,937)	(2,388)
Inventories	(2,475)	(731)	398
Other assets	(257)	1,079	(574)
Accounts payable	724	(1,043)	81
Accrued expenses	1,394	(1,453)	(1,990)
Income taxes payable	155	113	102
Net cash used in operating activities from continuing operations	(11,455)	(5,990)	(10,345)
Net cash provided by operating activities from discontinued operations	243	546	10,524
Net cash provided by (used in) operating activities	(11,212)	(5,444)	179
Cash flows from investing activities:			
Capital expenditures	(694)	(222)	(73)
Purchase of equity investments	(2,500)		
Proceeds from sale of assets, net	1,571	22	11
Sales and maturities of short-term investments	13,873	19,587	16,918
Purchases of short-term investments		(28,647)	(2,878)
Net cash provided by (used in) investing activities from continuing operations	12,250	(9,260)	13,978
Net cash provided by investing activities from discontinued operations			3,484
Net cash provided by (used in) investing activities	12,250	(9,260)	17,462
Cash flows from financing activities:			
Proceeds from issuance of common stock	18	109	262
Net cash provided by financing activities	18	109	262

Effect of exchange rates on cash and cash equivalents	894	1,092	540
Net increase (decrease) in cash and cash equivalents	1,950	(13,503)	18,443
Cash and cash equivalents, beginning of year	18,600	32,103	13,660
Cash and cash equivalents, end of year	$ 20,550	$ 18,600	$ 32,103
Supplemental disclosures of cash flow information:			
Income taxes paid	$ 194	$ 118	$ 133

See notes to consolidated financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

SCM Microsystems (SCM) was founded in 1990 in Munich, Germany and incorporated under the laws of the State of Delaware in December 1996. SCM s principal business activity is the design, development and sale of hardware and system solutions that enable people to conveniently and securely access digital content and services. SCM sells its products primarily in two market segments: Secure Authentication (previously referred to as PC Security) and Digital Media and Connectivity (previously referred to as Digital Media Readers). In the Secure Authentication market, SCM provides smart card reader technology that enables secure access to PCs, networks and physical facilities, as well as smart card-based productivity packages for small- and medium-sized businesses under the CHIPDRIVE brand. In the Digital Media and Connectivity market, SCM provides digital media readers that are used to transfer digital content to and from various digital flash media. SCM s target Secure Authentication customers are primarily original equipment manufacturers, or OEMs, who typically either bundle SCM s products with their own solutions, or repackage the products for resale to their customers. OEM customers typically sell SCM s smart card reader technology to government contractors, systems integrators, large enterprises and computer manufacturers, as well as to banks and other financial institutions. SCM s target Digital Media and Connectivity customers are computer and photo processing equipment manufacturers. SCM sells its CHIPDRIVE solutions through resellers and the Internet. SCM sells and licenses its products through a direct sales and marketing organization, as well as through distributors, value-added resellers and system integrators worldwide.

SCM maintains its corporate headquarters in Santa Ana, California and corporate offices in Ismaning, Germany, with additional facilities in India for research and development and in the United States and Japan for sales and marketing.

Principles of Consolidation and Basis of Presentation The accompanying consolidated financial statements include the accounts of SCM and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Discontinued Operations The financial information related to SCM s former Digital Television solutions (DTV solutions) business and retail Digital Media and Video business is reported as discontinued operations for all periods presented as discussed in Note 3.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires SCM s management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such management estimates include an allowance for doubtful accounts receivable, provision for inventory, lower of cost or market adjustments, valuation allowances against deferred income taxes, estimates related to recovery of long-lived assets, accruals of product warranty, restructuring accruals, and other liabilities. Estimates are revised as additional information becomes available. Actual results could differ from these estimates.

Cash Equivalents SCM considers all highly liquid debt investments with maturities of three months or less at the date of acquisition to be cash equivalents.

Short-term Investments Short-term investments consist of corporate notes and United States government agency instruments, and are stated at fair value based on quoted market prices. Short-term investments are classified as available-for-sale. The difference between amortized cost and fair value representing unrealized holding gains or losses is recorded as a component of stockholders equity as other cumulative comprehensive gain or loss. Gains and losses on sales of investments are determined on a specific identification basis. Short-term investments are evaluated for impairment on a quarterly basis and are written down to their fair value when impairment indicators present are considered to be other than temporary.

Fair Value of Financial Instruments SCM s financial instruments include cash and cash equivalents, short-term investments, trade receivables and payables, and long-term investments. At December 31, 2008 and 2007, the

Table of Contents

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

fair value of cash and cash equivalents, trade receivables and payables approximated their financial statement carrying amounts because of the short-term maturities of these instruments. (See Note 4 for fair value of investments.)

Inventories Inventories are stated at the lower of standard cost, which approximates cost, or market value. Cost is determined on the first-in, first-out method. An estimated provision is recorded for excess inventory, technical obsolescence and no ability to sell based primarily on historical sales and expectations for future use. Once inventory has been written down below cost, it is not subsequently written up.

Equity Investments SCM uses the equity method of accounting for investments in unconsolidated entities where the ability to exercise significant influence over such entities exists. Investments in unconsolidated entities consist of capital contributions plus SCM s share of accumulated earnings of the entities, less capital withdrawals and distributions. Investments in excess of the underlying net assets of equity method investees related to specifically identifiable intangible assets are amortized over the useful life of the related assets. Excess investment representing equity method goodwill is not amortized but is evaluated for impairment annually. Under the provisions of Statement of Financial Accounting Standard (SFAS) 142, this goodwill is not subject to amortization and is accounted for as a component of the investment. Equity method investments are subject to impairment under the provisions of Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.*

Property and Equipment Property and equipment are stated at cost. Depreciation and amortization are computed using the straight-line method over estimated useful lives of three to five years except for buildings which are depreciated over twenty-five to thirty years. Leasehold improvements are amortized over the shorter of the lease term or their estimated useful life.

Intangible and Long-lived Assets SCM evaluates long-lived assets under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets.* SCM evaluates its long-lived assets and certain identifiable intangibles for impairment 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 exceed 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, from two to five years.

Product warranties SCM accrues the estimated cost of product warranties at the time of sale. SCM s warranty obligation is affected by actual warranty costs, including material usage or service delivery costs incurred in correcting a product failure. If actual material usage or service delivery costs differ from estimates, revisions to the estimated warranty liability would be required.

Revenue Recognition SCM recognizes revenue pursuant to Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition.* 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. Maintenance revenue is deferred and amortized ratably over the period of the maintenance contract. Provisions for estimated warranty repairs and returns and allowances are provided for at the time of sale.

Research and Development Research and development expenses are expensed as incurred and consist primarily of employee compensation and fees for the development of prototype products.

Freight Costs SCM reflects the cost of shipping its products to customers as cost of revenue. Reimbursements received from customers for freight costs are not significant, but when received are recognized as revenue.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Income Taxes SCM accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires the asset and liability approach for financial accounting and reporting of income taxes. Deferred income taxes reflect the recognition of future tax consequences of events, that have been recognized in SCM s financial statements or tax returns. A valuation allowance is provided to reduce the net deferred tax asset to an amount that is more likely than not to be realized.

During the first quarter of fiscal 2007, SCM adopted the provisions of, and accounted for uncertain tax positions in accordance with the Financial Accounting Standards Board s (FASB) Interpretation No. 48, *Accounting For Uncertain Tax Positions* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

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. As a result of the adoption of FIN 48, SCM recognized a $1.5 million decrease to income taxes payable for uncertain tax positions. This decrease was accounted for as an adjustment to the beginning balance of accumulated deficit on the balance sheet. Including this decrease, at the beginning of 2007, SCM had $0.1 million of unrecognized tax benefits included in income taxes payable on the consolidated balance sheet. See Note 11 for further information regarding SCM s tax disclosures.

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

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

In conjunction with the adoption of SFAS 123(R), SCM changed its method of attributing the value of stock-based compensation to expense from the accelerated multiple-option approach to the straight-line single option method. Compensation expense for all share-based payment awards granted prior to January 1, 2006 will continue to be recognized using the accelerated multiple-option approach while compensation expense for all share-based payment awards granted on or subsequent to January 1, 2006 has been and will continue to be recognized using the straight-line single-option approach.

Net Income or Loss Per Share Basic and diluted net income or loss per share is based upon the weighted average number of common shares outstanding during the period. Diluted net income per share is based upon the weighted average number of common shares and dilutive-potential common share equivalents outstanding during the period. Dilutive-potential common share equivalents are excluded from the computation in loss periods as their effect would be antidilutive. If there is a loss from continuing operations, diluted net income per share would be computed in the same manner as basic net income per share is computed, even if an entity has net income after adjusting for a discontinued operation, an extraordinary item, or the cumulative effect of an accounting change.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Foreign Currency Translation and Transactions The functional currencies of SCM s foreign subsidiaries are the local currencies, except for the Singapore subsidiary, which uses the U.S. dollar as its functional currency. For those subsidiaries whose functional currency is the local currency, SCM translates assets and liabilities to U.S. dollars using period-end exchange rates and translate revenues and expenses using average exchange rates during the period. Exchange gains and losses arising from translation of foreign entity financial statements are included as a component of other comprehensive income (loss). Gains and losses from transactions denominated in currencies other than the functional currencies of SCM are included in other income and expense. SCM recorded a currency loss of $2.6 million in 2008, $0.3 million in 2007 and $0.3 million in 2006.

Concentration of Credit Risk Financial instruments that potentially expose SCM to concentrations of credit risk consist primarily of cash and cash equivalents, accounts receivable and short-term investments. SCM s cash equivalents primarily consist of money market accounts and commercial paper with maturities of less than three months. SCM primarily sells its products to companies in the United States, Asia and Europe. Two U.S.-based customers represented 29% and 18%, respectively, of the accounts receivable balance at December 31, 2008. SCM does not require collateral or other security to support accounts receivable. To reduce risk, SCM s management performs ongoing credit evaluations of its customers financial condition. SCM maintains allowances for potential credit losses.

Comprehensive Income (Loss) SFAS No. 130, *Reporting Comprehensive Income* requires an enterprise to report, by major components and as a single total, the change in net assets during the period from non-owner sources. Comprehensive income (loss) for the years ended December 31, 2008, 2007 and 2006 has been disclosed within the consolidated statements of stockholders equity and comprehensive income (loss).

Recently Issued Accounting Standards:

In December 2007, 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 SCM 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 SCM on a prospective basis for business combinations with an acquisition date beginning in the first quarter of fiscal year 2009. As of December 31, 2008, SCM did not have any minority interests.

On January 1, 2008, SCM 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.

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

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 SCM 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 SCM 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.

SCM 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, commercial paper and treasury bills) 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 December 31, 2008, SCM 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 December 31, 2008 were as follows (in thousands):

	Level 1	Level 2	Level 3	Total
Money market fund deposits	$ 9,426	$	$	$ 9,426

As of December 31, 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* , 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 (i.e., at least annually), until the beginning of the first quarter of fiscal 2009. The adoption of SFAS No. 157 to non-financial assets and non-financial liabilities is not expected to have a material impact to the consolidated financial statements of SCM.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Stockholders Equity and Stock-Based Compensation

Stockholders Rights Plan

On November 8, 2002, SCM s board of directors approved a stockholders rights plan. Under the plan, SCM declared a dividend of one preferred share purchase right for each share of SCM s common stock held by SCM stockholders of record as of the close of business on November 25, 2002. Each preferred share purchase right entitles the holder to purchase from SCM one one-thousandth of a share of Series A participating preferred stock, par value $0.001 per share, at a price of $30.00, subject to adjustment. The rights will become exercisable only upon the occurrence of certain events. If a person or group acquires, or announces a tender or exchange offer that would result in the acquisition of 15% or more of SCM s common stock while the stockholder rights plan remains in place, then, unless the rights are redeemed by SCM for $0.001 per right, the rights will become exercisable by all rights holders except the acquiring person or group for shares of SCM or the third-party acquirer having a value of twice the right s then-current exercise price. The stockholder rights plan may have the effect of deterring or delaying a change in control of SCM.

On December 10, 2008, SCM and the rights agent entered into the first amendment to the rights agreement to provide that the execution or delivery of the Hirsch merger agreement and the public announcement and consummation of the transactions contemplated by the merger agreement and the ancillary agreements will not cause: (i) the rights to purchase series A participating preferred stock pursuant to the rights agreement to become exercisable under the rights agreement; (ii) Hirsch or any of its affiliates to be deemed an Acquiring Person (as that term is used in the rights agreement); or (iii) a Triggering Event, the Distribution Date or the Shares Acquisition Date (as such terms are defined in the rights agreement) to occur.

Stock-Based Compensation Plans

SCM 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. Additionally, SCM 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 enrolment or the date of purchase. Shares issued as a result of stock option exercises and the ESPP are newly issued shares. SCM s ESPP, director option plan and 1997 stock option plan all expired in March 2007. In 2007, SCM s board of directors and its stockholders approved SCM s 2007 stock option plan, pursuant to which options to purchase 1.5 million shares of SCM s common stock may be granted. As of December 31, 2008, an aggregate of approximately 3.0 million shares of common stock was reserved for future issuance under SCM s stock option plans, of which 1.8 million shares were subject to outstanding options.

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

SCM elected to use the modified prospective transition method as permitted by SFAS 123(R) and therefore has not restated its financial results for prior periods. Under this transition method, in the three years ended December 31, 2008, the compensation cost recognized includes the cost for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. In conjunction with the adoption of SFAS 123(R), SCM changed its method of attributing the value of stock-based compensation to expense from the accelerated multiple-option

Table of Contents

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Compensation expense recognized in the consolidated statements of operations in the three years ended December 31, 2008 is based on awards ultimately expected to vest and reflects estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to adoption of SFAS 123(R) SCM accounted for forfeitures as they occurred.

In calculating the compensation cost, SCM estimates the fair value of each option grant on the date of grant using the Black-Scholes-Merton option 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.

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

The following table illustrates the stock-based compensation expense resulting from stock options and shares issued under the ESPP included in the consolidated statements of operations for the years ended December 31, 2008, 2007 and 2006:

		Year Ended	
	December 31, 2008	**December 31, 2007**	**December 31, 2006**
		(In thousands)	
Cost of revenue	$ 22	$ 63	$ 36
Research and development	50	73	110
Selling and marketing	119	233	163
General and administrative	164	356	323
Stock-based compensation expense before income Taxes	$ 355	$ 725	$ 632
Income tax benefit	0	0	
Stock-based compensation expense after income taxes	$ 355	$ 725	$ 632

Stock Option Plans

SCM s Director Option Plan and 1997 Stock Option Plan expired in March 2007 and as a result, 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 SCM s common stock pursuant to stock option grants. As of December 31, 2008, a total of

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1.1 million shares of SCM s common stock are reserved for future option grants under the 2000 Stock Option Plan and the 2007 Stock Option Plan, and 1.8 million shares were reserved for future issuance pursuant to outstanding options.

A summary of the activity under SCM s stock option plans for the three years ended December 31, 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 January 1, 2006 (2,099,539 exercisable at $20.56)	3,036,308	2,822,761	$ 16.26		
Options Authorized	35,000				
Options Granted	(376,794)	376,794	$ 3.26		
Options Cancelled or Expired	1,390,261	(1,390,261)	$ 17.71		
Options Exercised		(26,039)	$ 2.78	$ 8,716	
Balance at December 31, 2006 (1,208,481 exercisable at $17.02)	4,084,775	1,783,255	$ 12.58	$ 81,808	5.79
Options Authorized	1,500,000				
Options Granted	(506,181)	506,181	$ 3.83		
Options Cancelled or Expired	(3,585,101)	(414,726)	$ 9.38		
Options Exercised		(12,438)	$ 3.05	$ 9,085	
Balance at December 31, 2007 (1,260,320 exercisable at $14.51)	1,493,493	1,862,272	$ 10.97	$ 191,809	5.77
Options Authorized					
Options Granted	(596,001)	596,001	$ 3.01		
Options Cancelled or Expired	237,727	(615,332)	$ 16.68		
Options Exercised		(6,250)	$ 2.93	$ 1,507	
Balance at December 31, 2008	1,135,219	1,836,691	$ 6.51	$ 13,652	5.62
Vested or expected to vest at December 31, 2008		1,682,277	$ 6.81	$ 10,587	5.51
Exercisable at December 31, 2008		1,042,442	$ 9.04	$ 0	4.78

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes information about options outstanding as of December 31, 2008:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 1.50 - $ 3.05	568,155	6.42	$2.89	122,824	$2.89
$ 3.06 - $ 3.41	519,424	6.42	3.26	294,434	3.32
$ 3.44 - $ 5.86	374,198	6.55	4.29	250,270	4.31
$ 5.90 - $ 52.63	367,257	2.38	17.70	367,257	17.70
$ 63.00 - $ 83.00	7,657	0.43	66.92	7,657	66.92
$ 1.50 - $ 83.00	1,836,691	5.62	$6.51	1,042,442	$9.04

The weighted-average grant date fair value per option for options granted during the years ended December 31, 2008, 2007 and 2006 was $1.35, $1.80 and $1.71, respectively. Cash proceeds from the exercise of stock options were $18,000, $38,000 and $72,000 for the three years ended December 31, 2008, 2007 and 2006, respectively. At December 31, 2008, there was $0.8 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 2.6 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 years ended December 31, 2008, respectively:

	2008	2007	2006
Risk-free interest rate	2.49%	4.23%	4.81%
Expected volatility	58%	56%	67%
Expected term in years	4.00	4.00	3.92
Dividend yield	None	None	None

Expected Volatility: SCM s computation of expected volatility for the three years ended December 31, 2008 is based on the historical volatility of SCM s stock for a time period equivalent to the expected life.

Dividend Yield: The dividend yield assumption is based on SCM 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: SCM s expected term represents the period that SCM s stock-based awards are expected to be outstanding and was determined for the three years ended December 31, 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. Stock options are generally granted with vesting periods between one and five years.

Forfeiture Rates: Compensation expense recognized in the consolidated statement of operations for the three years ended December 31, 2008 is based on awards ultimately expected to vest, and reflects estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to adoption of SFAS 123(R), SCM accounted for forfeitures as they occurred.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1997 Employee Stock Purchase Plan

Until its expiration in March 2007, SCM s ESPP permitted eligible employees to purchase common stock through payroll deductions up to 10% of their base wages at a purchase price of 85% of the lower of fair market value of the common stock at the beginning or end of each offering period. SCM 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. SCM s ESPP restricted the maximum amount of shares purchased by an individual to $25,000 worth of common stock each year. During 2008, 2007 and 2006, a total of zero, 27,145 and 78,679 shares, respectively, were issued under the plan. As of December 31, 2008, no shares were available for future issuance under SCM s ESPP, due to the plan s expiration in March 2007.

The fair value of issuances under SCM s ESPP was estimated on the issuance date by applying the principles of FASB Technical Bulletin 97-1 (FTB 97-1), *Accounting under Statement 123 for Certain Employee Stock Purchase Plan with a Look Back Option*, and using the Black-Scholes-Merton option pricing model. Stock-based compensation expense related to SCM s ESPP recognized under SFAS 123(R) for the year ended December 31, 2007 was a benefit of $40,000. The benefit stemmed from the expiration of the plan before the expected offering periods had terminated. At December 31, 2008, there was no further unrecognized stock-based compensation expense related to outstanding ESPP shares as the plan expired in March 2007.

The following weighted average assumptions are included in the estimated grant date fair value calculations for rights to purchase stock under the ESPP:

	2008	2007	2006
Expected life			15 months
Risk-free interest			4.90%
Volatility			49%
Dividend yield			None

The weighted-average fair value of purchase rights granted under the Purchase Plan in 2006 was $1.36 per share.

3. Discontinued Operations

On May 22, 2006, SCM 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 the fiscal years ended December 31, 2008, 2007 and 2006, the DTV solutions business has been presented as discontinued operations in the consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

Based on the carrying value of the assets and the liabilities attributed to the DTV solutions business on May 22, 2006, and the estimated costs and expenses incurred in connection with the sale, SCM 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 SCM 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 SCM 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.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The operating results for the discontinued operations of the DTV solutions business for the fiscal years ended December 31, 2008, 2007 and 2006 are as follows:

	Years Ended December 31,		
	2008	2007	2006
		(In thousands)	
Net revenue	$	$ 496	$ 13,513
Operating gain (loss)	$ 2	$ 61	$ (1,287)
Income before income taxes	$ 2	$ 84	$ 2,953
Income tax benefit	$	$	$ 67
Gain from discontinued operations	$ 2	$ 84	$ 3,020

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

In April 2008, SCM entered into an agreement to terminate its lease agreement for premises leased in the UK, which related to the discontinued Digital Media and Video business. This transaction resulted in a gain on sale of discontinued operations of approximately $0.4 million in the second quarter of 2008, which is the major portion of the $0.6 million gain on sale of discontinued operations for the year 2008. The remaining $0.2 million was mainly related to changes in estimates for lease commitments.

During 2007, net gain on disposal of the retail Digital Media and Video business was $0.1 million, which was mainly related to changes in estimates for lease commitments.

During 2006, net loss on disposal of the retail Digital Media and Video business was $0.1 million, which was mainly related to changes in estimates for lease commitments.

The operating results for the discontinued operations of the retail Digital Media and Video business for the years ended December 31, 2008, 2007 and 2006 are as follows:

	Years Ended December 31,		
	2008	2007	2006
		(In thousands)	
Net revenue	$	$	$
Operating loss	$ (329)	$ (304)	$ (168)
Income (loss) before income taxes	$ 662	$ (207)	$ (76)
Income tax benefit (provision)	$ (877)	$ (92)	$ 564
Gain (loss) from discontinued operations	$ (215)	$ (299)	$ 488

The operating loss for the Digital Media and Video business resulted from general and administrative expenses for the discontinued entities in the U.S. and UK, mainly in connection with the long-term lease agreements from the discontinued operations.

The income before income taxes in 2008 mainly resulted from foreign exchange gains in the second half of 2008.

The income tax provision mainly relates to a deferred tax liability for undistributed earnings and profits of an SCM subsidiary, which are not considered to be permanently invested.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Short-Term Investments

At December 31, 2008, the amount of short-term investments was zero. The fair value of short-term investments at December 31, 2007 was as follows:

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

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

5. Inventories

Inventories consist of:

	December 31,	
	2008	2007
	(In thousands)	
Raw materials	$ 1,648	$ 1,202
Finished goods	3,417	1,536
Total	$ 5,065	$ 2,738

6. Equity Investments

Equity investments consist of:

	December 31,	
	2008	2007
	(In thousands)	
TranZfinity, Inc.	$ 2,244	$

On October 1, 2008, SCM entered into a Stock Purchase Agreement with TranZfinity, a privately held entity, pursuant to which SCM purchased a 33.7% ownership interest for an aggregate purchase price of $2.5 million. This investment is accounted for using the equity method of accounting.

As of the time of the initial investment, the purchase price exceeded SCM s proportionate share of the assets acquired and liabilities assumed by approximately $1.9 million. The difference was attributable to intangibles of $0.1 million and equity method goodwill of $1.8 million. The excess investment relating to intangibles was mainly amortized in 2008 due to the nature of the intangibles. Such amortization amounted to $0.1 million for the year ended December 31, 2008 and has been recorded as a reduction of equity in earnings of unconsolidated equity method investees. The equity-method goodwill is not amortized in accordance with SFAS 142; however, it is analyzed for impairment annually.

For the year ended December 31, 2008, SCM recorded a loss of $0.2 million for its share of the losses realized by TranZfinity.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Property and Equipment

Property and equipment, net consist of:

	December 31, 2008	December 31, 2007
	(In thousands)	
Land	$	$ 142
Building and leasehold improvements	1,734	1,972
Furniture, fixtures and office equipment	2,777	3,223
Automobiles	28	35
Purchased software	3,233	3,526
Total	7,772	8,898
Accumulated depreciation	(6,536)	(7,376)
Property and equipment, net	$ 1,236	$ 1,522

SCM recorded depreciation expense in the amount of $0.3 million for each of the years ended December 31, 2008, 2007 and 2006.

8. Intangible Assets

SCM entered into an Exclusive Cooperation Agreement (the Agreement) on April 17, 2008 with TranZfinity. Under the terms of the Agreement, as amended, TranZfinity works with SCM to develop modular USB devices for SCM s product portfolio and will supply SCM s customers with TranZfinity s application software and services supporting those devices. Pursuant to the Agreement, SCM is obligated to pay TranZfinity up to $1.0 million exclusivity fee for the right to be the exclusive provider of those products (the Exclusive Products) of which $0.3 million was paid as of December 31, 2008. SCM capitalized these prepayments and is recording amortization expense based on the estimated useful life.

		December 31, 2008		
	Amortization Period	Gross Carrying Value	Accumulated Amortization	Net
		(In thousands)		
Exclusivity right	54 months	$ 321	$ (14)	$ 307

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, SCM s intangible assets are subject to amortization. SCM evaluates long-lived assets under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Amortization expense related to intangible assets for continuing operations was $14,000, $0.3 million and $0.7 million for the years ended December 31, 2008, 2007 and 2006, respectively. Amortization expense resulting from the exclusivity right is recorded as part of cost of revenue.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Fiscal Year	Amount
2009	$ 71
2010	71
2011	71
2012	71
2013	23
Total	$ 307

9. Restructuring and Other Charges

Continuing Operations

During 2008, SCM incurred no restructuring and other charges related to continuing operations. During 2007, SCM realized income from the reversal of a severance accrual related to continuing operations of $4,000. During 2006, SCM incurred net restructuring and other charges related to continuing operations of approximately $1.4 million.

Accrued liabilities related to restructuring actions and other activities during 2008, 2007 and 2006 consist of the following:

	Lease/Contract Commitments	Severance	Other Costs	Total
		(In thousands)		
Balances as of January 1, 2006	$ 32	$ 152	$ 9	$ 193
Provision for 2006	33	1,320		1,353
Changes in estimates	(2)	4		2
	31	1,324		1,355
Payments and other changes in 2006	(48)	(1,370)		(1,418)
Balances as of December 31, 2006	15	106	9	130
Provision for 2007				
Changes in estimates		(4)		(4)
		(4)		(4)
Payments and other changes in 2007	(3)	(102)	1	(104)

Balances as of December 31, 2007	12		$ 10	22
Provision for 2008				
Changes in estimates				
Payments and other changes in 2008	(5)		(1)	(6)
Balances as of December 31, 2008	$ 7	$	$ 9	$ 16

For the year ended December 31, 2006, restructuring and other charges primarily related to severance costs in connection with a reduction in force resulting from SCM s decision to transfer all manufacturing operations from its Singapore facility to contract manufacturers as well as the decision to transfer the corporate headquarter functions from California to Germany and local finance functions from the U.S. and Singapore to Germany. Approximately $0.3 million of the restructuring amount related to severance for manufacturing personnel and was therefore

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

recorded in cost of revenue. The remaining $1.1 million was recorded in operating expenses and was primarily made up of severance for non-manufacturing personnel.

Discontinued Operations

During 2008 and 2007, SCM recorded $0.6 million and $0.1 million of income within discontinued operations which resulted from the reversal of accruals related to prior restructuring activity of disposed businesses. During 2006 SCM incurred restructuring and other charges related to discontinued operations of approximately $0.1 million.

Accrued liabilities related to restructuring actions and other activities during 2008, 2007 and 2006 consist of the following:

	Lease/Contract Commitments	Other Costs	Total
	(In thousands)		
Balances as of January 1, 2006	3,198	506	3,704
Provision for 2006	2	5	7
Changes in estimates	87		87
	89	5	94
Payments and other changes in 2006	(338)	(159)	(497)
Balances as of December 31, 2006	2,949	352	3,301
Provision for 2007			
Changes in estimates	(70)	(40)	(110)
	(70)	(40)	(110)
Payments and other changes in 2007	(290)	37	(253)
Balances as of December 31, 2007	2,589	349	2,938
Provision for 2008			
Changes in estimates	(594)		(594)
	(594)		(594)
Payments and other changes in 2008	(765)	(19)	(784)
Balances as of December 31, 2008	$ 1,230	$ 330	$ 1,560

Income from discontinued operations for the year ended December 31, 2008 was $0.6 million. This primarily related to a net gain of $0.4 million in the second quarter of 2008, which resulted from a termination payment and related transaction costs incurred of $0.5 million, offset by the reversal of related restructuring accruals of $0.9 million, which related to the termination of SCM s lease agreement for premises leased in the UK. The remaining $0.2 million was primarily related to changes in estimates for lease commitments.

Income from discontinued operations for the fiscal year ended December 31, 2007 primarily related to changes in estimates for lease obligations.

Discontinued operation costs for the fiscal year ended December 31, 2006 primarily related to changes in estimates for lease obligations.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Gain on Sale of Assets

On October 30, 2008, SCM sold at an auction certain non-strategic patents that are unrelated to SCM s current business to a third party for cash of $1.4 million, net of costs, and recognized a gain of $1.4 million on the transaction.

11. Income Taxes

Loss before income taxes for domestic and non-U.S. continuing operations is as follows:

	2008	2007	2006
		(In thousands)	
Income (loss) from continuing operations before income taxes:			
U.S.	$ (1,669)	$ 1,113	$ (2,709)
Foreign	(8,065)	(4,292)	(4,908)
Loss from continuing operations before income taxes	$ (9,734)	$ (3,179)	$ (7,617)

The benefit (provision) for income taxes consisted of the following:

		December 31,	
	2008	2007	2006
		(In thousands)	
Deferred:			
Federal	$	$	$
State	(370)		
Foreign	(11)	26	(2)
	(381)	26	(2)
Current			
Federal	(4)	(35)	
State	(79)	(31)	(4)
Foreign	(288)	(73)	(67)
	(371)	(139)	(71)
Total provision for income taxes	$ (752)	$ (113)	$ (73)

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Significant items making up deferred tax assets and liabilities are as follows:

	December 31,	
	2008	2007
	(In thousands)	
Deferred tax assets:		
Allowances not currently deductible for tax purposes	$ 651	$ 842
Net operating loss carryforwards	41,419	39,924
Accrued and other	485	440
	42,555	41,206
Less valuation allowance	(37,982)	(41,206)
	4,573	0
Deferred tax liability:		
Other	(5,913)	(77)
Net deferred tax liability	$ (1,340)	$ (77)

During the years ended December 31, 2008 and 2007, SCM recognized a benefit of $0.7 million and $0.5 million, respectively, from the utilization of net operating loss carryforwards for which SCM had previously established a full valuation allowance. Because of the full valuation allowance recorded for the deferred tax assets, the benefit from the utilization of this tax attribute had not been previously recognized.

The net deferred tax liabilities are from foreign and state tax liabilities. Federal and state deferred tax assets cannot be used to offset foreign deferred tax liabilities. The state deferred tax liabilities result from the 2008 and 2009 state suspension of the use of net operating loss carryforwards.

The provision for taxes reconciles to the amount computed by applying the statutory federal rate to loss before income taxes from continuing operations as follows:

	2008	2007	2006
Computed expected tax benefit	34%	34%	34%
State taxes, net of federal benefit	(0)%	(1)%	
Foreign taxes benefits provided for at rates other than U.S. statutory rate	(3)%	3%	10%
Change in valuation allowance	(30)%	(15)%	(44)%
Permanent Differences	(6)%	(24)%	(1)%
Other	(3)%	(1)%	(0)%

Effective income tax expense rate	(8)%	(4)%	(1)%

As of December 31, 2008, SCM has net operating loss carryforwards of approximately $69.8 million for federal, $31.5 million for state and $63.4 million for foreign income tax purposes. If not utilized, these carryforwards will begin to expire beginning in 2012 for federal purposes and have already begun to expire for state and foreign purposes.

The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. In the event SCM has a change in ownership, utilization of the carryforwards could be restricted.

SCM intends to distribute earnings from two of its foreign subsidiaries and deferred taxes have been calculated for this future distribution. SCM has no present intention of remitting undistributed earnings of other foreign subsidiaries, and accordingly, no deferred tax liability has been established relative to these undistributed earnings.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the first quarter of fiscal 2007, SCM adopted the provisions of, and accounted for uncertain tax positions in accordance with FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

As a result of adoption of FIN 48, unrecognized tax benefits were reclassified to long-term income taxes payable, where applicable.

As a result of the implementation, SCM recognized a $1.5 million decrease to income taxes payable for uncertain tax positions. This decrease was accounted for as an adjustment to the beginning balance of accumulated deficit as of January 1, 2007 on the consolidated balance sheet.

A reconciliation of the beginning and ending amount of unrecognized tax benefits with an impact on SCM s consolidated balance sheets or results of operations is as follows:

	2008	2007
	(In thousands)	
Balance at January 1	$ 157	$ 142
Additions based on tax positions related to the current year	54	
Additions for tax positions of prior years	2	15
Reductions for tax positions of prior years	(77)	
Settlements		
Balance at December 31	$ 136	$ 157

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

In addition, as of December 31, 2008 and 2007, SCM determined $2.1 million and $4.1 million, respectively, in liability for unrecognized tax benefits, which was accounted for as a decrease to deferred tax assets which had a full valuation allowance against them and has no impact on SCM s consolidated balance sheets or results of operations for the years 2008 and 2007. The reduction during 2008 is mainly the result of the settlement of tax positions with the taxing authority of one of SCM s foreign subsidiaries during Q4 2008.

SCM recognizes interest and penalties related to uncertain tax positions in income tax expense. As of December 31, 2008 and 2007, approximately $48,000 and $43,000, respectively, of accrued interest and penalties related to uncertain tax positions.

SCM files U.S. federal, U.S. state and foreign tax returns. SCM is generally no longer subject to tax examinations for years prior to 2000. However, if loss carryforwards of tax years prior to 2000 are utilized in the U.S., these tax years may become subject to investigation by the tax authorities.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Net Income (Loss) Per Common Share

The following is a reconciliation of the numerators and denominators used in computing basic and diluted net income (loss) per common share:

	Years Ended December 31,		
	2008	2007	2006
	(In thousands, except per share amounts)		
Loss from continuing operations	$ (10,486)	$ (3,292)	$ (7,690)
Discontinued operations	376	1,371	8,732
Net income (loss)	$ (10,110)	$ (1,921)	$ 1,042
Shares (denominator):			
Weighted average common shares outstanding used in computation of basic and diluted income (loss) per share	15,743	15,725	15,638
Income (loss) per share Basic and diluted:			
Continuing operations	$ (0.66)	$ (0.21)	$ (0.49)
Discontinued operations	0.02	0.09	0.56
Net income (loss)	$ (0.64)	$ (0.12)	$ 0.07

As SCM has incurred losses from continuing operations during each of the last three fiscal years, shares issuable under stock options are excluded from the computation of diluted earnings per share as their effect is anti-dilutive. Common stock equivalent shares issuable under stock options (which are in-the-money) and their weighted average exercise price for the three years ended December 31, 2008 are as follows:

	Years Ended December 31,		
	2008	2007	2006
Common equivalent shares issuable	195	30,554	24,094
Weighted average exercise price of shares issuable	$ 1.58	$ 3.00	$ 2.78

13. Segment Reporting, Geographic Information and Major Customers

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

SCM s continuing operations provide secure digital access solutions to OEM customers in two markets segments: Secure Authentication and Digital Media and Connectivity. The Secure Authentication segment was previously referred to as PC Security, but the nomenclature has been revised to better reflect the broader range of applications SCM now addresses, including contactless payment, electronic healthcare, logical and physical access and other applications that require secure authentication of users. The Digital Media and Connectivity segment was previously referred to as Digital Media Readers, but the nomenclature was revised to better reflect the benefits of SCM s readers as connectivity solutions.

The executive staff reviews financial information and business performance along these two business segments. SCM evaluates the performance of its segments at the revenue and gross margin level. SCM s reporting

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

systems do not track or allocate operating expenses or assets by segment. SCM does not include intercompany transfers between segments for management purposes.

On May 22, 2006, SCM completed the sale of substantially all the assets and some of the liabilities associated with its DTV solutions business to Kudelski. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the fiscal years ended December 31, 2008, 2007 and 2006, this business has been presented as discontinued operations in the consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

Summary information by segment for the years ended December 31, 2008, 2007 and 2006 is as follows:

	Years Ended December 31,		
	2008	**2007**	**2006**
		(In thousands)	
Secure Authentication			
Revenues	$ 23,711	$ 24,427	$ 23,745
Gross profit	10,910	10,472	9,725
Gross profit %	46%	43%	41%
Digital Media and Connectivity			
Revenues	$ 4,651	$ 6,008	$ 9,868
Gross profit	1,635	2,182	2,132
Gross profit %	35%	36%	22%
Total:			
Revenues	$ 28,362	$ 30,435	$ 33,613
Gross profit	12,545	12,654	11,857
Gross profit %	44%	42%	35%

Geographic revenue is based on selling location. Information regarding revenue by geographic region is as follows:

	Years Ended December 31,		
	2008	**2007**	**2006**
		(In thousands)	
Revenues			
United States	$ 12,176	$ 15,744	$ 14,695
Europe	9,860	8,722	13,294
Asia-Pacific	6,326	5,969	5,624
Total	$ 28,362	$ 30,435	$ 33,613

% of revenues

United States	43%	51%	43%
Europe	35%	29%	40%
Asia-Pacific	22%	20%	17%

Two customers exceeded 10% of total revenue for 2008 and one customer exceeded 10% of total revenue for each of 2007 and 2006. Two U.S. based customers represented 29% and 18%, respectively of SCM s accounts receivable balance at December 31, 2008 and two U.S. based customers represented 30% and 15%, respectively of SCM s accounts receivable balance at December 31, 2007.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Long-lived assets by geographic location as of December 2008 and 2007 are as follows:

	December 31, 2008	December 31, 2007
	(In thousands)	
Property and equipment, net:		
United States	$ 5	$ 14
Europe	259	171
Asia-Pacific	972	1,337
Total	$ 1,236	$ 1,522

$0.9 million of the long-lived assets as of December 31, 2008 and all of the long-lived assets as of December 31, 2007, disclosed for Asia-Pacific, relate to SCM s facilities in India.

14. Commitments

SCM leases its facilities, certain equipment, and automobiles under non-cancelable operating lease agreements. These lease agreements expire at various dates during the next five years for agreements existing as of December 31, 2008.

Future minimum lease payments under non-cancelable operating leases as of December 31, 2008 are as follows for the years ending:

	(In thousands)
2009	$ 1,501
2010	1,321
2011	635
2012	443
2013	377
Committed gross lease payments	4,277
Less: sublease rental income	(24)
Net operating lease obligation	$ 4,253

At December 31, 2008, SCM accrued approximately $1.2 million of restructuring charges in connection with a portion of the above lease commitments. Rent expense from continuing operations was $1.2 million, $1.2 million and $1.5 million in 2008, 2007 and 2006, respectively.

Purchases for inventories are highly dependent upon forecasts of the customers demand. Due to the uncertainty in demand from its customers, SCM may have to change, reschedule, or cancel purchases or purchase orders from its suppliers. These changes may lead to vendor cancellation charges on these purchases or contractual commitments. As of December 31, 2008, purchase and contractual commitments due within one year were approximately $10.0 million, and additional purchase and contractual commitments due within two years were approximately $2.9 million.

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

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Components of the reserve for warranty costs during the years ended December 31, 2008, 2007 and 2006 were as follows:

	Continuing Operations	Discontinued Operations	Total
		(In thousands)	
Balance at January 1, 2006	56	97	153
Additions related to current period sales	215	12	227
Warranty costs incurred in the current period	(64)	(13)	(77)
Adjustments to accruals related to prior period sales	(173)	(96)	(269)
Balance at December 31, 2006	34	0	34
Additions related to current period sales	67		67
Warranty costs incurred in the current period	(61)		(61)
Adjustments to accruals related to prior period sales	(4)		(4)
Balance at December 31, 2007	36	$ 0	$ 36
Additions related to current period sales	35		35
Warranty costs incurred in the current period	(20)		(20)
Adjustments to accruals related to prior period sales	(35)		(35)
Balance at December 31, 2008	$ 16	$ 0	$ 16

15. Related-Party Transactions

On October 1, 2008, SCM entered into a Stock Purchase Agreement with TranZfinity, a privately held entity, pursuant to which SCM purchased a 33.7% ownership interest for an aggregate purchase price of $2.5 million. Felix Marx, CEO of SCM, has served since October on the board of directors of TranZfinity.

SCM entered into an Exclusive Cooperation Agreement (the Agreement) on April 17, 2008, with TranZfinity, which was amended in October 2008. Under the terms of the Agreement, as amended, TranZfinity is working with SCM to develop modular USB devices for SCM s product portfolio and will supply SCM s customers with TranZfinity s application software and services supporting those devices. Pursuant to the Agreement, SCM is obligated to pay TranZfinity up to $1.0 million exclusivity fee for the right to be the exclusive provider of those products (the Exclusive Products) of which $0.3 million was paid as of December 31, 2008. SCM capitalized these prepayments and is recording amortization expense based on the estimated useful life.

In addition to the exclusivity fee, SCM will pay TranZfinity a five percent (5%) royalty on SCM s net selling price for each Exclusive Product sold by SCM as soon as the first products are sold. During 2008, SCM paid no royalty fee to TranZfinity.

During the period during which SCM owned its 33.7% ownership interest, TranZfinity had total revenues of $0 and a net loss of $0.6 million with total assets of approximately $1.8 million.

SCM accounts for the investment in TranZfinity using the equity method of accounting. For the year ended December 31, 2008, SCM recorded a loss of $0.2 million for its share of the losses realized by TranZfinity.

Werner Koepf, SCM s Chairman of the Board, also served until June 2007 as a director and as a member of the Audit Committee and the Compensation Committee of Gemalto N.V. (formerly Gemalto N.V. International S.A.), a company engaged in the development, production and distribution of smart-card based systems. During 2008, SCM incurred license expenses of approximately $42,000 to Gemalto N.V., which related to continuing operations.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

License expenses of approximately $0.1 million and $0.2 million were incurred for 2007 and 2006 respectively, of which approximately $80,000 and $76,000 related to continuing operations. As of December 31, 2008, approximately $9,000 was due as accounts payable to Gemalto N.V. As of December 31, 2007, no accounts payable were due to Gemalto N.V. As of December 31, 2006, approximately $30,000 was due as accounts payable to Gemalto N.V. During 2008 SCM realized no revenue from sales to Gemalto N.V. During 2007 and 2006, SCM realized revenue of approximately $0.2 million and $11,000, respectively, from sales to Gemalto N.V. As of December 31, 2008 and December 31, 2007, no accounts receivable were outstanding from Gemalto N.V. As of December 31, 2006, approximately $11,000 was due as accounts receivable from Gemalto N.V. SCM s business relationship with Gemalto N.V. has been in existence for many years and predates Werner Koepf s appointment to SCM s board of directors in February 2006. Mr. Koepf was not directly compensated for revenue transactions between the two companies. The related-party transactions have been performed following at arm s length principles.

16. Legal Proceedings

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

On March 18, 2009, Secure Keyboards, Ltd. (Secure Keyboards) and two of its general partners, Luis Villalobos and Howard B. Miller, filed a complaint against SCM, Felix Marx, SCM s Chief Executive Officer, and Hirsch, in Los Angeles Superior Court (Case No. SC102226). The complaint asserts multiple causes of action, including interference with contract, in connection with the prospective merger of SCM and Hirsch and a 1994 settlement agreement entered into among Secure Keyboards, Hirsch, and Secure Networks, Ltd (the Settlement Agreement). The Settlement Agreement calls for royalty payments to be made from Hirsch to each of Secure Keyboards and Secure Networks, Ltd. The complaint alleges that the letter of understanding interfered with the Settlement Agreement in a manner which harmed Secure Keyboards interests. The Plaintiffs are seeking damages, including approximately $20,200,000, and declaratory relief. The initial case management review and conference is scheduled for July 6, 2009. SCM believes that the claims in this case are without merit and it intends to defend the case vigorously, but until a final decision is made with respect to the Plaintiffs allegations, no assurances can be given that the ultimate disposition of this case will not have a material adverse effect on SCM s business, financial condition and results of operations.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

17. Quarterly Results of Operations (Unaudited)

The following is a summary of the unaudited quarterly results of operations for 2008 and 2007:

	Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data) (Unaudited)			
2008:				
Net revenue	$ 6,464	$ 6,520	$ 6,393	$ 8,985
Gross profit	2,683	2,823	2,910	4,129
Loss from operations	(2,016)	(2,307)	(2,047)	(1,227)
Loss from continuing operations	(1,570)	(1,978)	(3,267)	(3,671)
Gain (loss) from discontinued operations, net of income taxes	(125)	(26)	424	(486)
Gain (loss) on sale of discontinued operations, net of income taxes	13	496	44	36
Net income (loss)	(1,682)	(1,508)	(2,799)	(4,121)
Basic and diluted income (loss) per share from continuing operations	$ (0.10)	$ (0.13)	$ (0.21)	$ (0.22)
Basic and diluted income (loss) per share from discontinued operations	$ (0.01)	$ 0.03	$ 0.03	$ (0.03)
Basic and diluted net income (loss) per share	$ (0.11)	$ (0.10)	$ (0.18)	$ (0.25)
Shares used to compute basic income (loss) per share:	15,741	15,744	15,744	15,744
Shares used to compute diluted income (loss) per share:	15,741	15,744	15,744	15,744

	Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data) (Unaudited)			
2007:				
Net revenue	$ 8,457	$ 4,647	$ 7,617	$ 9,714
Gross profit	3,740	1,333	3,447	4,134
Income (loss) from operations	(114)	(4,053)	(363)	58
Income (loss) from continuing operations	134	(3,673)	(116)	363
Gain (loss) from discontinued operations, net of income taxes	(17)	(102)	(83)	(13)
	23	1,530	16	17

Gain (loss) on sale of discontinued operations, net of income taxes				
Net income (loss)	140	(2,245)	(183)	367
Basic and diluted income (loss) per share from continuing operations	$ 0.01	$ (0.23)	$ (0.01)	$ 0.02
Basic and diluted income (loss) per share from discontinued operations	$ (0.00)	$ 0.09	$ (0.00)	$ 0.00
Basic and diluted net income (loss) per share	$ 0.01	$ (0.14)	$ (0.01)	$ 0.02
Shares used to compute basic income (loss) per share:	15,700	15,730	15,736	15,736
Shares used to compute diluted income (loss) per share:	15,742	15,730	15,736	15,759

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(In thousands, except per share data) (Unaudited)			
Net revenue	$ 10,961	$ 6,520	$ 16,116	$ 12,984
Cost of revenue	5,390	3,697	8,432	7,478
Gross profit	5,571	2,823	7,684	5,506
Operating expenses:				
Research and development	1,489	1,043	2,258	2,078
Selling and marketing	3,739	2,569	5,983	4,730
General and administrative	2,199	1,518	4,686	3,021
Gain on sale of assets			(249)	
Total operating expenses	7,427	5,130	12,678	9,829
Loss from operations	(1,856)	(2,307)	(4,994)	(4,323)
Loss on equity investments	(281)		(570)	
Interest and other income (expense), net	(212)	330	67	824
Loss from continuing operations before income taxes	(2,349)	(1,977)	(5,497)	(3,499)
Benefit (provision) for income taxes	1,739	(1)	1,740	(48)
Loss from continuing operations	(610)	(1,978)	(3,757)	(3,547)
Income (loss) from discontinued operations, net of income taxes	84	(26)	151	(151)
Gain on sale of discontinued operations, net of income taxes	38	496	75	509
Net loss	$ (488)	$ (1,508)	$ (3,531)	$ (3,189)
Loss per share from continuing operations:				
Basic and diluted	$ (0.03)	$ (0.13)	$ (0.20)	$ (0.22)
Gain per share from discontinued operations:				
Basic and diluted	$ 0.01	$ 0.03	$ 0.01	$ 0.02
Net loss per share:				
Basic and diluted	$ (0.02)	$ (0.10)	$ (0.19)	$ (0.20)
Shares used to compute basic and diluted loss per share	22,039	15,744	18,891	15,742

Comprehensive loss:				
Net loss	$ (488)	$ (1,508)	$ (3,531)	$ (3,189)
Unrealized gain (loss) on investments		(5)		28
Foreign currency translation adjustment	282	(516)	(417)	(179)
Total comprehensive loss	$ (206)	$ (2,029)	$ (3,948)	$ (3,340)

See notes to condensed consolidated financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

	June 30, 2009	December 31, 2008
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,309	$ 20,550
Accounts receivable, net of allowances of $579 and $689 as of June 30, 2009 and December 31, 2008, respectively	9,723	8,665
Inventories	7,652	5,065
Income taxes receivable	765	
Other current assets	1,521	1,139
Total current assets	24,970	35,419
Equity investments	1,674	2,244
Property and equipment, net	1,446	1,236
Intangible assets, net	23,017	307
Goodwill	21,895	
Other assets	1,211	1,932
Total assets	$ 74,213	$ 41,138
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable to bank	$ 81	$
Accounts payable	5,713	3,555
Liability to related parties	1,030	
Accrued compensation and related benefits	1,285	1,763
Accrued restructuring and other charges	1,296	1,576
Accrued professional fees	958	1,419
Accrued royalties	491	475
Accrued sales tax related expenses	332	330
Other accrued expenses	1,909	1,959
Income taxes payable	415	411
Total current liabilities	13,510	11,488
Long-term liability to related parties	8,018	
Deferred tax liability	4,154	1,340
Long-term income taxes payable	377	184
Commitments and contingencies (see Notes 10 and 11)		
Stockholders equity:		

Common stock, $0.001 par value: 40,000 shares authorized; 25,753 and 16,362 shares issued and 25,135 and 15,744 shares outstanding as of June 20, 2009 and December 31, 2008, respectively		26		16
Additional paid-in capital		253,754		229,788
Treasury stock, 618 shares		(2,777)		(2,777)
Accumulated deficit		(205,730)		(202,199)
Accumulated other comprehensive income		2,881		3,298
Total stockholders equity		48,154		28,126
Total liabilities and stockholders equity	$	74,213	$	41,138

See notes to condensed consolidated financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30	
	2009	2008
	(In thousands)	(Unaudited)
Cash flows from operating activities:		
Net loss	$ (3,531)	$ (3,189)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Gain from discontinued operations	(225)	(358)
Depreciation and amortization	351	152
Gain on disposal of fixed assets	(249)	
Stock compensation expense	191	125
Deferred income taxes	(1,935)	4
Loss on equity investments	570	
Changes in operating assets and liabilities:		
Accounts receivable	1,798	1,265
Inventories	(901)	(1,396)
Other assets	35	(131)
Income taxes receivable	319	
Accounts payable	338	(217)
Accounts payable to related parties	132	
Accrued expenses	(1,193)	174
Other liabilities	6	
Income taxes payable	(19)	(21)
Net cash used in operating activities from continuing operations	(4,313)	(3,592)
Net cash provided by (used in) operating activities from discontinued operations	401	(664)
Net cash used in operating activities	(3,912)	(4,256)
Cash flows from investing activities:		
Capital expenditures	(246)	(159)
Cash paid for Hirsch acquisition	(14,167)	
Cash acquired in Hirsch acquisition	3,275	
Proceeds from disposal of fixed assets	249	
Maturities of short-term investments		13,873
Net cash provided by (used in) investing activities	(10,889)	(13,714)
Cash flows from financing activities:		
Proceeds from issuance of equity securities, net		18
Net cash provided by financing activities		18

Effect of exchange rates on cash and cash equivalents		(440)		(85)
Net increase (decrease) in cash and cash equivalents		(15,241)		9,391
Cash and cash equivalents at beginning of period		20,550		18,600
Cash and cash equivalents at end of period	$	5,309	$	27,991
Supplemental disclosures of cash flow information:				
Income tax refunds received	$	(319)	$	
Income taxes paid	$	183	$	51

See notes to condensed consolidated financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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 SCM Microsystems, Inc. s (SCM or the Company) financial position, results of operations and cash flows have been included. Operating results for the three and six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009 or any future period. For further information, refer to the financial statements and notes thereto included in SCM s Annual Report on Form 10-K for the year ended December 31, 2008. The preparation of unaudited condensed consolidated financial statements necessarily requires SCM 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.

On April 30, 2009, SCM acquired Hirsch Electronics Corporation (Hirsch), a privately-held California corporation. The results for the acquired Hirsch business are included in SCM s consolidated statements of operations since the date of acquisition on April 30, 2009. As a result of the timing of this transaction, SCM s condensed consolidated results for the periods presented are not directly comparable.

Discontinued Operations

During 2006, SCM completed the sale of substantially all the assets and some of the liabilities associated with its Digital Television solutions (DTV solutions) business. During 2003, SCM completed two transactions to sell its retail Digital Media and Video business.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets* (SFAS 144), for the periods ended June 30, 2009 and 2008, these businesses have 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 4 for further discussion of these transactions.

Recent Accounting Pronouncements and Accounting Changes

In June 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 168, *The FASB Accounting Standards Codification^{tm} and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162,* (SFAS 168). SFAS 168 replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles,* and establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Rules and interpretive releases of the Securities and Exchange Commission under authority of federal securities laws are also sources of authoritative GAAP for Securities and Exchange Commission 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. SFAS 168 becomes effective for SCM for the period ending September 30, 2009. Management has determined that the adoption of SFAS 168 will not have an impact on SCM s financial statements.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On January 1, 2009, SCM adopted SFAS No. 141 (revised 2007), *business combinations* (SFAS 141(R)), which replaces SFAS No. 141, *business combinations* (SFAS 141) but retains the fundamental requirements in SFAS 141, including that the purchase method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. Under SFAS 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 141(R) changes SCM s accounting treatment for business combinations on a prospective basis.

On January 1, 2009, SCM adopted SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* (SFAS 160). SFAS 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 SCM on a prospective basis for business combinations with an acquisition date beginning in the first quarter of fiscal year 2009. As of June 30, 2009, SCM did not have any minority interests.

On January 1, 2009, SCM adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157), 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. The adoption of SFAS 157, as it relates to nonfinancial assets and nonfinancial liabilities, had no impact on SCM s financial statements.

On January 1, 2009, SCM adopted FASB Staff Position (FSP) No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*, (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*, (SFAS 142) in order to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other GAAP. The adoption of FSP FAS 142-3 had no impact on SCM s financial statements.

On January 1, 2008, SCM adopted SFAS 157 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 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. SFAS 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 157 did not have a significant impact on SCM s consolidated financial statements, and the resulting fair values calculated under SFAS 157 after adoption were not significantly different than the fair values that would have been calculated under previous guidance.

SFAS 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 SCM 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 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

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

SCM 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, commercial paper and treasury bills) 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, 2009, SCM had 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, 2009 were as follows (in thousands):

	Level 1	Level 2	Level 3	Total
Money market fund deposits	$ 1,553	$	$	$ 1,553

Non-financial assets that are measured and recognized at fair value on a non-recurring basis are as follows (in thousands):

	Level 1	Level 2	Level 3	Total
Goodwill	$	$	$ 21,895	$ 21,895
Acquired intangibles Hirsch Acquisition			22,583	22,583
Total:	$	$	$ 44,478	$ 44,478

The valuation of the acquired intangible assets is classified as a Level 3 measurement, because it was based on significant unobservable inputs and involved management judgment and assumptions about market participants and pricing. In determining fair value of the acquired intangible assets, SCM determined the appropriate unit of measure, the exit market and the highest and best use for the assets, as per SFAS 157. The fair value of acquired trade names and existing technology was determined using relief from royalty approach and the fair value of the acquired company s customer relationships was determined excess earnings approach. See Note 2 for discussion of this acquisition. The discount rate used in the valuation of the intangible assets was derived from a weighted average cost of capital analysis.

As of June 30, 2009, there were no liabilities that are measured and recognized at fair value on a recurring basis.

2. Acquisition of Hirsch Electronics

On April 30, 2009 (the closing date or the acquisition date), SCM 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). In accordance with the Agreement and Plan of Merger entered into on December 10, 2008 by and among SCM, Hirsch and two wholly-owned subsidiaries of SCM, through a two-step merger Hirsch became Hirsch Electronics LLC, a Delaware limited liability company and a wholly-owned subsidiary of SCM.

Hirsch sells its products and services in many countries worldwide, through dealers and systems integrators. The majority of sales are in the United States, followed by Europe and Asia. Hirsch products are sold in every major industry segment, with the highest number of sales occurring in market segments requiring a higher-than-average level of security effectiveness, such as government, critical infrastructure, banking, healthcare and education.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SCM believes that the acquisition of Hirsch presents a strategic opportunity to strengthen its position in the security industry, expand its product offerings and customer base, and increase its operational scale, among other benefits. The purpose of the acquisition is to provide SCM with additional scale and resources to develop, sell and support new products, systems and services to address the growing global market for security and identity solutions to enable e-commerce, e-government and e-business.

In exchange for all of the outstanding capital stock of Hirsch, SCM paid approximately $14.2 million in cash, issued approximately 9.4 million shares of SCM common stock at the closing and issued warrants to purchase approximately 4.7 million shares of SCM common stock at an exercise price of $3.00 with a five-year term, exercisable for two years following the third anniversary of the closing date. In addition, each warrant to purchase shares of Hirsch common stock outstanding immediately prior to the effective date of the acquisition was converted into a warrant to purchase the number of shares of SCM common stock equal to the number of shares of Hirsch common stock that could have been purchased upon the full exercise of such warrants, multiplied by the conversion ratio (as defined below), rounded down to the nearest whole share. The per share exercise price for each new warrant to purchase SCM common stock was determined by dividing the per share exercise price of the Hirsch common stock subject to each warrant as in effect immediately prior to the effective date of the acquisition by the conversion ratio, and rounding that result up to the nearest cent. As used in this Quarterly Report on Form 10-Q, conversion ratio means the quotient obtained by dividing the estimated aggregate value of the acquisition consideration per share of Hirsch common stock, by the 30-day volume weighted average price of SCM s common stock (as reported on the NASDAQ Stock Market during the 30 days preceding the day prior to the day of the effective date of the acquisition).

After giving effect to the acquisition of Hirsch, former Hirsch shareholders beneficially own approximately 37% of the shares of SCM common stock outstanding. Lawrence Midland, a former Hirsch director and President of the Hirsch subsidiary, joined SCM s Board of Directors on May 1, 2009 and also became an executive officer of SCM. Douglas Morgan, a former director of Hirsch, also joined the board of directors of SCM immediately following the acquisition. Other than the addition of Mr. Midland, SCM s executive staff remains unchanged as a result of the acquisition.

The acquisition is being accounted for under the acquisition method of accounting under SFAS 141(R). Under this method of accounting, the total purchase consideration is measured at fair value as of the acquisition date when control is obtained, which for the acquisition of Hirsch was determined to be April 30, 2009. SCM has obtained a third-party valuation report to calculate the fair value of the consideration transferred and to measure the identifiable intangible assets acquired and liabilities to related parties assumed. The total purchase consideration was determined to be $38.0 million as of the acquisition date. The following table summarizes the consideration paid for Hirsch and the amounts of the assets acquired and liabilities assumed at the acquisition date. The fair value of the shares of SCM common stock issued in connection with the acquisition was determined using the closing price of SCM s common stock as of the acquisition date of $2.37 per share.

Fair value of consideration transferred (in thousands):

Cash paid for Hirsch common stock	$ 14,167
Fair value of common stock issued	22,258
Fair value of warrants issued	1,327

Fair value of warrants converted	200
Total purchase consideration	$ 37,952

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Purchase price allocation as of April 30, 2009 (in thousands):

Cash and cash equivalents	$ 3,275
Accounts receivable, net	2,832
Inventories	1,649
Other assets	437
Deferred income taxes and taxes receivable	1,085
Property and equipment	262
Amortizable intangible assets:	
Developed technology	4,600
Customer relationships	10,350
Intangible assets with indefinite lives (unamortizable):	
Trade names	7,800
Accounts payable	(1,814)
Accrued expenses	(467)
Other liabilities	(192)
Deferred tax liabilities and taxes payable	(1,957)
Deferred tax liabilities in connection with acquired tangibles assets with indefinite lives	(3,003)
Fair value of liabilities assumed to related parties	(8,800)
Goodwill	21,895
Total purchase consideration	$ 37,952

As SCM finalizes certain valuation assumptions, adjustments may be recorded in the related purchase price allocation.

The identified intangible assets of $22.8 million consist of core technology, trade names and customer relationships. Developed technology relates to Hirsch s current products. Customer relationships relate to Hirsch s ability to sell existing, in-process and future versions of its products to its existing customers. Trade names represent future value to be derived associated with the use of existing trade names. SCM expects to amortize developed technology and customer relationships on a straight-line basis over their expected useful life of 15 years. Assumed liabilities to related parties are estimated based on contractual payments to be made in future periods through 2020. SCM has estimated the acquisition date fair value of this liability to be $8.8 million, based on a discounted cash flow valuation technique.

Of the total purchase consideration, $21.9 million was recognized as goodwill. Goodwill represents the excess of the purchase consideration of an acquired business over the fair value of the underlying net assets and liabilities. The goodwill arising from the acquisition is largely attributable to the synergies expected to be realized after SCM s acquisition and integration of Hirsch. Hirsch s results are included in SCM s reportable segment, Security and Identity Solutions (formerly called Secure Authentication). None of the goodwill recorded as part of the Hirsch acquisition will be deductible for United States federal income tax purposes.

Deferred tax assets and liabilities resulting from the acquisition of Hirsch have been netted, where applicable. As the identified intangible asset trade names has an indefinite life, the deferred tax liability of $3.0 million relating to the value of the trade names cannot be offset with deferred tax assets with a definite life. Resulting from these procedures, deferred tax liabilities of $1.7 million after netting with deferred tax assets and $3.0 million deferred tax liabilities relating to the indefinite life intangible asset have been considered in the purchase price allocation.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Following the acquisition, Hirsch Electronics LLC has become part of the U.S. tax group of the SCM entities. Accordingly, the deferred tax liability of $1.7 million, as described above, has been netted with SCM s existing deferred tax assets. The carrying value of SCM s net deferred tax assets reflects that SCM has 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 SCM is able to realize their benefit, or that future deductibility is uncertain. As a result of netting the deferred tax liability of $1.7 million with SCM s existing deferred tax assets, there is a $1.7 million release of SCM s valuation allowance. In accordance with SFAS 141(R), the release of the valuation allowance has been booked as a tax benefit in the 2009 second quarter financial statements.

Management evaluates the realizability of the deferred tax assets quarterly. At June 30, 2009, SCM has recorded valuation allowances against all of its net deferred tax assets. The deferred tax assets are still available for SCM to use in the future to offset taxable income, which would result in the recognition of a tax benefit and a reduction in the effective tax rate. Actual operating results and the underlying amount and category of income in future years could render SCM s current assumptions, judgments and estimates of the realizability of deferred tax assets inaccurate, which could have a material impact on SCM s financial position or results of operations.

Pro forma financial information:

The results for the acquired Hirsch business are included in SCM s consolidated statements of operations since the date of acquisition on April 30, 2009. As a result of the timing of this transaction, SCM s condensed consolidated results for the periods presented are not directly comparable. The pro forma financial information is presented for informational purposes only and is not intended to represent or be indicative of the results of operations that would have been achieved if the acquisition had been completed as of the date indicated, and should not be taken as representative of future consolidated results of operations or financial condition of SCM. The unaudited pro forma financial information in the table below summarizes the combined results of operations of SCM and Hirsch, as though the acquisition had occurred as of the beginning of the periods presented. Preparation of the pro forma financial information for all periods presented required management to make certain judgments and estimates to determine the pro forma adjustments such as purchase accounting adjustments, which include, among others, cost of sales resulted from step up of inventory at fair value, amortization charges from acquired intangible assets, and income tax effects.

Pro forma results of operations for the three and six months ended June 30, 2009 and 2008 are as follows (in thousands, unaudited):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2009	**2008**	**2009**	**2008**
Revenues	$ 12,234	$ 12,098	$ 22,776	$ 24,514
Net loss	(2,012)	(2,367)	(6,409)	(4,253)
Weighted average common shares outstanding used in loss per common share basic and diluted	25,135	25,135	25,135	25,133

Net loss per common share basic and diluted	$	(0.08)	$	(0.09)	$	(0.25)	$	(0.17)

3. Stock Based Compensation and Warrants

SCM 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

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

As of June 30, 2009, an aggregate of approximately 2.9 million shares of SCM s common stock was reserved for future issuance under SCM s stock option plans, of which 2.4 million shares were subject to outstanding options.

In calculating stock-based compensation cost, SCM 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 included in the unaudited condensed consolidated statements of operations for the three and six months ended June 30, 2009 and 2008 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Cost of revenue	$ 7	$ (2)	$ 13	$ 10
Research and development	16	6	27	25
Selling and marketing	44	6	74	62
General and administrative	63	37	77	28
Stock-based compensation expense before income taxes	$ 130	$ 47	$ 191	$ 125
Income tax benefit	0	0	0	0
Stock-based compensation expense after income taxes	$ 130	$ 47	$ 191	$ 125

Stock Option Plans

SCM 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 SCM s common stock pursuant to stock option grants. As of June 30, 2009, a total of 519,727 shares of SCM s common stock are reserved for future option grants under the 2000 Stock Option Plan and the 2007 Stock Option Plan, and 2,380,981 shares were reserved for future issuance pursuant to outstanding options.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the activity under SCM s stock option plans for the six months ended June 30, 2009 is as follows:

	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, 2008	1,135,219	1,836,691	$ 6.51	$ 13,652	5.62
Options granted	(672,877)	672,877	$ 2.39		
Options cancelled or expired	57,385	(128,587)	$ 12.21		
Balance at June 30, 2009	519,727	2,380,981	$ 5.04	$ 30,731	5.71
Vested or expected to vest at June 30, 2009		2,122,918	$ 5.31	$ 25,258	5.59
Exercisable at June 30, 2009		1,064,120	$ 7.82	$ 50	4.60

The weighted-average grant date fair value per option for options granted during both the three and six months ended June 30, 2009 was $1.35. 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. During the three and six months ended June 30, 2009, no options were exercised. The total intrinsic value of options exercised during the three and six months ended June 30, 2008 was $0 and $1,500, 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. At June 30, 2009, there was $1.3 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, 2009 and 2008, respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2008	2008
Expected volatility	75%	54%	71%	54%
Dividend yield	0	0	0	0
Risk-free interest rate	1.86%	3.13%	1.69%	2.64%

Expected term (in years)	4.00	4.00	4.00	4.00

Expected Volatility: SCM s computation of expected volatility for the three and six months ended June 30, 2009 is based on the historical volatility of SCM s stock for a time period equivalent to the expected term.

Dividend Yield: The dividend yield assumption is based on SCM 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: SCM s expected term represents the period that SCM s stock-based awards are expected to be outstanding and was determined for the three and six months ended June 30, 2009 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 the three and six months ended June 30, 2009 and 2008 is based on awards ultimately expected to vest and it reflects

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Warrants

As described in Note 2, as part of the consideration paid by SCM in connection with the acquisition of Hirsch, SCM issued approximately 4.7 million warrants in exchange for the outstanding capital stock of Hirsch at an exercise price of $3.00. Also, as part of the consideration, SCM issued 205,072 warrants for outstanding Hirsch warrants at exercise prices in the range between $2.42 and $3.03 with a weighted average exercise price of $2.79.

All warrants will become exercisable for a period of two years on April 30, 2012.

4. Discontinued Operations

On May 22, 2006, SCM 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 was paid in May 2007.

In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and six months ended June 30, 2009 and 2008, the DTV solutions business has been presented as discontinued operations in the consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

Based on the carrying value of the assets and the liabilities attributed to the DTV solutions business on May 22, 2006, and the estimated costs and expenses incurred in connection with the sale, SCM 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.

The operating results for the discontinued operations of the DTV solutions business for the three and six months ended June 30, 2009 and 2008 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Operating gain (loss)	$ (4)	$ (2)	$ 74	$ (6)
Income (loss) before income taxes	$ (4)	$ (2)	$ 89	$ (6)
Income tax benefit (provision)	$	$	$	$
Income (loss) from discontinued operations	$ (4)	$ (2)	$ 89	$ (6)

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

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The operating results for the discontinued operations of the retail Digital Media and Video business for the three and six months ended June 30, 2009 and 2008 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Operating loss	$ (64)	$ (62)	$ (146)	$ (144)
Net income (loss) before income taxes	$ 91	$ (22)	$ 32	$ (140)
Income tax benefit (provision)	$ (3)	$ (2)	$ 30	$ (5)
Gain (loss) from discontinued operations	$ 88	$ (24)	$ 62	$ (145)

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

5. Inventories

Inventories consist of (in thousands):

	June 30, 2009	December 31, 2008
Raw materials	$ 2,114	$ 1,648
Work-in-process	6 63	
Finished goods	4,875	3,417
Total	$ 7,652	$ 5,065

6. Equity Investments

Equity investments consist of (in thousands):

	June 30, 2009	December 31, 2008
TranZfinity, Inc.	$ 1,674	$ 2,244

On October 1, 2008, SCM entered into a Stock Purchase Agreement with TranZfinity, a privately held entity, pursuant to which SCM purchased a 33.7% ownership interest for an aggregate purchase price of $2.5 million. This investment is accounted for using the equity method of accounting.

As of the time of the initial investment, the purchase price exceeded SCM s proportionate share of the assets acquired and liabilities assumed by approximately $1.9 million. The difference was attributable to intangibles of $0.1 million and equity method goodwill of $1.8 million. The excess investment relating to intangibles was mainly amortized in 2008 due to the nature of the intangibles. The equity-method goodwill is not amortized in accordance with SFAS 142; however, it is analyzed for impairment, at least on an annual basis. In case of adverse circumstances arising which may impact the value of its investments, SCM also evaluates whether indications for impairment exist on a case by case basis.

For the three and six months ended June 30, 2009, SCM recorded a loss of $0.3 million and $0.6 million, respectively, for its share of the losses reported by TranZfinity.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Property and Equipment

Property and equipment consists of (in thousands):

	June 30, 2009	December 31, 2008
Building and leasehold impovements	$ 1,772	$ 1,734
Furniture, fixtures and office equipment	3,165	2,777
Automobiles	28	28
Purchased software	3,260	3,233
Total	8,225	7,772
Accumulated depreciation	(6,779)	(6,536)
Property and equipment, net	$ 1,446	$ 1,236

Depreciation expense was $0.1 million and $0.3 million for the three and six months ended June 30, 2009, respectively, and $0.1 million and $0.2 million for the three and six months ended June 30, 2008, respectively.

8. Goodwill and Intangible Assets

Goodwill

During the six months ended June 30, 2009, SCM recorded goodwill in connection with SCM s acquisition of Hirsch of $21.9 million. The goodwill is recorded in the reportable segment Security and Identity Solutions .

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), SCM tests its goodwill and any other intangibles with indefinite lives annually for impairment and assesses whether there are any indicators of impairment on an interim basis. Management did not identify any impairment indicators during the three months ended June 30, 2009.

Intangible Assets Hirsch Acquisition

As discussed in Note 2, during the six months ended June 30, 2009, SCM acquired other intangible assets of $22.8 million in connection with the acquisition of Hirsch, of which $15.0 million are related to existing technology and customer relationships and are subject to amortization, and $7.8 million are related to trade names which are determined to have an indefinite useful life.

Trade names are not subject to amortization in accordance with SFAS 142; however, they are reviewed for impairment on an annual basis, or more frequently if events or changes in circumstances indicate that the asset might be impaired.

The following table summarizes the gross carrying amount and accumulated amortization for the intangible assets resulting from the Hirsch acquisition with definite lives:

	June 30, 2009			
	Amortization Period	Gross Carrying Value	Accumulated Amortization	Net
		(In thousands)		
Existing technology	15 years	$ 4,600	$ (52)	$ 4,548
Customer relationships	15 years	$ 10,350	$ (115)	$ 10,235
Totals		$ 14,950	$ (167)	$ 14,783

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

These intangible assets will be amortized over their useful lives. Amortization expense of these acquired intangible assets for the three months ended June 30, 2009 was $0.2 million, of which $0.1 million was included in cost of revenue and $0.1 million was included in selling and marketing expense in the statements of operations.

For the second half of 2009, amortization expenses for the intangible assets resulting from the Hirsch acquisition of $0.5 million are expected. Amortization expenses of $1.0 million per year are expected for the years 2010 through 2023 and $0.3 million is expected for 2024.

Intangible Assets TranZfinity

SCM entered into an Exclusive Cooperation Agreement (the Cooperation Agreement) on April 17, 2008 with TranZfinity. Under the terms of the Cooperation Agreement, as amended, TranZfinity works with SCM to develop modular USB devices for SCM s product portfolio and will supply SCM s customers with TranZfinity s application software and services supporting those devices. Pursuant to the Cooperation Agreement, SCM is obligated to pay TranZfinity up to $1.0 million exclusivity fee for the right to be the exclusive provider of those products (the Exclusive Products), of which $0.3 million was paid in the fourth quarter of 2008 and $0.2 million was paid in the first quarter of 2009. SCM is recording amortization expense based on the estimated useful life.

		June 30, 2009			December 31, 2008		
	Amortization Period	Gross Carrying Value	Accumulated Amortization	Net	Gross Carrying Value	Accumulated Amortization	Net
			(In thousands)				
Exclusivity right	54 months	$ 500	$ (66)	$ 434	$ 321	$ (14)	$ 307

In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, SCM s intangible assets TranZfinity are subject to amortization. SCM evaluates long-lived assets under SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Amortization expense related to these intangible assets was $29,000 and $52,000 for the three and six months ended June 30, 2009, respectively and zero for the three and six months ended June 30, 2008, respectively and was included in the cost of revenue in the statements of operations.

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

Fiscal Year	Amount
2009	$ 57
2010	114
2011	114
2012	114

2013	35
Total	$ 434

9. Restructuring and Other Charges

Discontinued Operations

During the three and six months ended June 30, 2009, income from restructuring and other items related to discontinued operations was approximately $38,000 and $75,000, respectively.

During both the three and six months ended June 30, 2008, income from restructuring and other items related to discontinued operations was approximately $0.5 million, which related primarily to an agreement to terminate the lease for premises leased in the UK in April 2008. A termination payment and related transaction costs of

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

approximately $0.5 million were incurred and the related restructuring accruals of approximately $0.9 million were released. The transaction resulted in a net gain of approximately $0.4 million from discontinued operations.

Accrued liabilities related to the Digital Media and Video restructuring actions and other activities during the six months ended June 30, 2009 and during the year ended December 31, 2008 consist of the following (in thousands):

	Lease/Contract Commitments	Other Costs	Total
Balances as of January 1, 2008	$ 2,589	$ 349	$ 2,938
Provision for 2008			
Changes in estimates	(594)		(594)
	(594)		(594)
Payments and other changes in 2008	(765)	(19)	(784)
Balances as of December 31, 2008	1,230	330	1,560
Provision for Q1 2009			
Changes in estimates	(37)		(37)
	(37)		(37)
Payments and other changes in Q1 2009	(98)	(16)	(114)
Balances as of March 31, 2009	1,095	314	1,409
Provision for Q2 2009			
Changes in estimates	(38)		(38)
	(38)		(38)
Payments and other changes in Q2 2009	(98)	18	(80)
Balances as of June 30, 2009	$ 959	$ 332	$ 1,291

Continuing Operations

During the three and six months ended June 30, 2008, SCM incurred no restructuring and other charges related to continuing operations.

Restructuring accruals from continuing operations were $5,000 and $16,000 as of June 30, 2009 and December 31, 2008, respectively.

10. Gain on Sale of Assets

In March 2009, SCM sold at auction certain non-strategic patents that are unrelated to its current business, for cash of $0.2 million, net of costs, and recognized a gain of $0.2 million on the transaction.

11. Segment Reporting, Geographic Information and Major Customers

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

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SCM s continuing operations provide secure security and identity solutions in two primary market segments: Security and Identity Solutions (formerly called Secure Authentication) and Digital Media and Connectivity. The acquired Hirsch business has been included in the segment Security and Identity Solutions. The executive staff reviews financial information and business performance along these two business segments. SCM evaluates the performance of its segments at the revenue and gross margin level. SCM s reporting systems do not track or allocate operating expenses or assets by segment. SCM does not include intercompany transfers between segments for management purposes.

Summary information by segment for the three and six months ended June 30, 2009 and 2008 is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Security and Identity Solutions				
Net revenue	$ 10,028	$ 4,878	$ 13,971	$ 9,885
Gross profit	5,251	2,276	$ 6,929	$ 4,423
Gross profit %	52%	47%	50%	45%
Digital Media and Connectivity				
Net revenue	$ 933	$ 1,642	$ 2,145	$ 3,099
Gross profit	320	547	$ 755	$ 1,083
Gross profit %	34%	33%	35%	35%
Total:				
Net revenue	$ 10,961	$ 6,520	$ 16,116	$ 12,984
Gross profit	5,571	2,823	7,684	5,506
Gross profit %	51%	43%	48%	42%

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net revenue				
Europe	$ 2,471	$ 2,697	$ 4,641	$ 5,087
United States	6,535	2,449	8,653	4,560
Asia-Pacific	1,955	1,374	2,822	3,337

Total	$ 10,961	$ 6,520	$ 16,116	$ 12,984
% of net revenue				
Europe	22%	41%	28%	39%
United States	60%	38%	54%	35%
Asia-Pacific	18%	21%	18%	26%

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Long-lived assets by geographic location as of June 30, 2009 and December 31, 2008, are as follows (in thousands):

	June 30, 2009	December 31, 2008
Property and equipment, net:		
United States	$ 274	$ 5
Europe	249	259
Asia-Pacific	923	972
Total	$ 1,446	$ 1,236

All of the long-lived assets as of June 30, 2009 and December 31, 2008 disclosed for Asia-Pacific relate to SCM s facilities in India.

12. Commitments

SCM leases its facilities, certain equipment, and automobiles under noncancelable operating lease agreements. Those lease agreements existing as of June 30, 2009 expire at various dates during the next five years.

Purchases for inventories are highly dependent upon forecasts of customer demand. Due to the uncertainty in demand from its customers, SCM may have to change, reschedule, or cancel purchases or purchase orders from its suppliers. These changes may lead to vendor cancellation charges on these purchases or contractual commitments. As of June 30, 2009, purchase and contractual commitments due within one year were approximately $9.6 million, and additional purchase and contractual commitments due within two years were approximately $1.9 million.

SCM provides warranties on certain product sales, which range from twelve to twenty-four months, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires SCM to make estimates of product return rates and expected costs to repair or to replace the products under warranty. SCM currently establishes warranty reserves based on historical warranty costs for each product line combined with liability estimates based on the prior twelve months sales activities. If actual return rates and/or repair and replacement costs differ significantly from SCM s estimates, adjustments to recognize additional cost of sales may be required in future periods. As of June 30, 2009, no material accruals for warranties were recorded.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Net Income (Loss) per Common Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net loss from continuing operations	$ (610)	$ (1,978)	$ (3,757)	$ (3,547)
Income from discontinued operations	122	470	226	358
Net income (loss)	$ (488)	$ (1,508)	$ (3,531)	$ (3,189)
Weighted average common shares outstanding used in income (loss) per common share basic and diluted	22,039	15,744	18,891	15,742
Net income (loss) per common share basic and diluted				
Continuing operations	$ (0.03)	$ (0.13)	$ (0.20)	$ (0.22)
Discontinued operations	$ 0.01	$ 0.03	$ 0.01	$ 0.02
Net income (loss) per common share basic and diluted	$ (0.02)	$ (0.10)	$ (0.19)	$ (0.20)

The computation of diluted net income per common share for the three and six months ended June 30, 2009 excludes the effect of the potential exercise of options to purchase approximately 2,000 shares, because the effect would be anti-dilutive in periods when there is a net loss. The computation of diluted net income per common share for the three and six months ended June 30, 2009 also excludes the effect of the potential exercise of options to purchase approximately 2.0 million and 1.9 million shares of common stock, respectively, because the option exercise price was greater than the average market price of the shares and the effect would have been anti-dilutive.

The computation of diluted net loss per common share for the three and six months ended June 30, 2008 excludes the effect of the potential exercise of options to purchase approximately 3,000 and 7,000 shares, respectively, because the effect would be anti-dilutive in periods when there is a net loss. The computation of diluted net loss per common share for the three and six months ended June 30, 2008 also excludes the effect of the potential exercise of options to purchase approximately 1.9 million and 1.8 million common shares, respectively, because the option exercise price was greater than the average market price of the shares and the effect would have been anti-dilutive.

14. Related Party Transactions

Prior to the acquisition of Hirsch by SCM, effective November 1994, Hirsch had entered into a settlement agreement (the 1994 Settlement Agreement) with two limited partnerships, Secure Keyboards, Ltd. (Secure Keyboards) and Secure Networks, Ltd. (Secure Networks). Under the terms of a previous agreement, Hirsch had purchased the exclusive rights to certain patents and technology from Secure Keyboards and Secure Networks.

Secure Keyboards and Secure Networks were related to Hirsch through certain common shareholders and limited partners, including Hirsch s President Lawrence Midland, who is now an Executive Vice President of SCM. Following the acquisition, Mr. Midland continues to own 22% of Secure Keyboards and 9% of Secure Networks.

On April 8, 2009, Secure Keyboards, Secure Networks and Hirsch amended and restated the 1994 Settlement Agreement to replace the royalty-based payment arrangement under the 1994 Settlement Agreement with a new, definitive installment payment schedule with contractual payments to be made in future periods through 2020 (the 2009 Settlement Agreement). Hirsch s initial annual payment to Secure Keyboards and Secure Networks under the 2009 Settlement Agreement for the period from January 1, 2009 through December 31, 2009 will be $986,000, with subsequent annual payments subject to increase based on the percentage increase in the Consumer Price Index during the prior calendar year.

SCM MICROSYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The final payment to Secure Networks is due on January 30, 2012 and the final payment to Secure Keyboards is due on January 30, 2021. Hirsch s payment obligations under the 2009 Settlement Agreement will continue through the calendar year period ending December 31, 2020, unless Hirsch elects at any time on or after January 1, 2012 to earlier satisfy its obligations by making a lump-sum payment to Secure Keyboards. The amount of the lump-sum payment will be based on an assumed growth rate of the remaining annual payments of 4%, in lieu of the percentage increase in the Consumer Price Index, and a discount rate of 9%.

Prior to the acquisition of Hirsch by SCM, SCM was not a party to the 2009 Settlement Agreement. SCM has, however, provided Secure Keyboards and Secure Networks with a limited guarantee of Hirsch s payment obligations under the 2009 Settlement Agreement (the Guarantee). The 2009 Settlement Agreement and the Guarantee became effective upon the acquisition of Hirsch on April 30, 2009.

During the period from April 30, 2009 to June 30, 2009, $0.1 million expense was recognized by SCM in its statement of operations for the interest accreted on the discounted liability amount.

15. Legal Proceedings

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

On March 18, 2009, Secure Keyboards and two of its general partners, Luis Villalobos and Howard B. Miller, filed suit in Los Angeles Superior Court (the Action) against SCM, Felix Marx, SCM s Chief Executive Officer, and Hirsch. The plaintiffs alleged multiple causes of action, including interference with contract in connection with the acquisition of Hirsch by SCM and the 1994 Settlement Agreement entered into by and among Secure Keyboards, Hirsch and Secure Networks, and sought damages, including approximately $20,200,000, and declaratory relief. See Note 2 for additional information concerning the Hirsch acquisition.

On April 8, 2009, SCM, Mr. Marx, Secure Keyboards, Secure Networks, each of the respective general partners of Secure Keyboards and Secure Networks, and Hirsch entered into a settlement agreement (the 2009 Settlement Agreement), pursuant to which the parties resolved the disputes that had arisen between them relating to the acquisition and the 1994 Settlement Agreement. In connection with the 2009 Settlement Agreement, on April 9, 2009 the plaintiffs dismissed the Action without prejudice and agreed to dismiss said Action with prejudice after the closing of the acquisition of Hirsch. The acquisition of Hirsch closed on April 30, 2009. On May 5, 2009, the plaintiffs dismissed the Action with prejudice. The 2009 Settlement Agreement also contains releases among the parties, and those releases became effective upon the closing of the acquisition.

Prior to the acquisition of Hirsch by SCM, SCM was not a party to the 2009 Settlement Agreement. SCM has, however, provided Secure Keyboards and Secure Networks with a limited guarantee of Hirsch s payment obligations under the 2009 Settlement Agreement (the Guarantee). The 2009 Settlement Agreement and the Guarantee became fully effective and binding upon the closing of the acquisition of Hirsch.

For additional information on the terms of the 2009 Settlement Agreement see Note 14.

HIRSCH ELECTRONICS CORPORATION

INDEX TO FINANCIAL STATEMENTS

Independent Auditors Report	F-52
Balance Sheets as of November 30, 2008 and 2007	F-53
Statements of Operations for the Years Ended November 30, 2008, 2007 and 2006	F-54
Statement of Stockholders Equity for the Years Ended November 30, 2008, 2007 and 2006	F-55
Statements of Cash Flows for the Years Ended November 30, 2008, 2007 and 2006	F-56
Notes to Financial Statements	F-57

Table of Contents

INDEPENDENT AUDITORS   REPORT

To the Board of Directors and Stockholders
Hirsch Electronics Corporation

We have audited the accompanying balance sheets of Hirsch Electronics Corporation (the   Company) as of November 30, 2008, 2007 and 2006, and the related statements of operations, stockholders   equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, the financial statements referred to above present fairly, in all material respects, the financial position of Hirsch Electronics Corporation as of November 30, 2008, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Newport Beach, California
January 26, 2009

HIRSCH ELECTRONICS CORPORATION

BALANCE SHEETS
November 30, 2008, 2007 and 2006

	2008	2007	2006
		(In thousands)	
ASSETS			
Current Assets			
Cash and cash equivalents	$ 4,932	$ 5,014	$ 4,031
Accounts receivable, net	3,137	3,996	2,844
Inventories	1,871	1,587	1,444
Prepaid expenses	226	200	200
Note receivable	54	54	54
Income taxes receivable	1,023		62
Deferred tax asset	245	129	93
Total current assets	11,488	10,980	8,728
Property and Equipment, net	262	254	271
Investments	48	397	397
Patents, net	39	45	51
Deferred Tax Asset	191	45	15
Other Assets	37	37	37
Total assets	$ 12,065	$ 11,758	$ 9,499
LIABILITIES AND STOCKHOLDERS EQUITY			
Current Liabilities			
Accounts payable and accrued expenses	$ 1,009	$ 525	$ 611
Royalties payable to related parties	349	390	356
Income taxes payable		345	54
Other accrued liabilities	764	317	238
Put option derivative liability	518		
Deferred revenue	68	115	
Total current liabilities	2,708	1,692	1,259
Commitments and Contingencies			
Stockholders Equity			
Common stock, no par value; 5,000 shares authorized; 4,606, 4,582, and 4,578 shares issued and outstanding at November 30, 2008, 2007 and 2006, respectively	4,566	4,302	4,216
Notes receivable for common stock		(65)	(105)
Retained earnings	4,791	5,829	4,129

Total stockholders equity	9,357	10,066	8,240
Total liabilities and stockholders equity	$ 12,065	$ 11,758	$ 9,499

The accompanying notes are an integral part of these financial statements.

HIRSCH ELECTRONICS CORPORATION

STATEMENTS OF OPERATIONS
Years Ended November 30, 2008, 2007 and 2006

	2008	2007	2006
		(In thousands)	
Net revenues	$ 23,042	$ 21,990	$ 20,883
Cost of revenues	9,988	9,370	8,747
Royalties to related parties	1,028	993	938
Gross profit	12,026	11,627	11,198
Operating expenses:			
Selling, general and administrative	9,576	8,055	7,416
Research and development	3,310	780	729
Depreciation and amortization	100	159	138
	12,986	8,994	8,283
(Loss) income from operations	(960)	2,633	2,915
Other (loss) income	(742)	216	139
(Loss) income before provisions for income taxes	(1,702)	2,849	3,054
Provision for income tax (benefit) expense	(664)	1,149	1,091
Net (loss) income	$ (1,038)	$ 1,700	$ 1,963

The accompanying notes are an integral part of these financial statements.

HIRSCH ELECTRONICS CORPORATION

STATEMENT OF STOCKHOLDERS EQUITY
Years Ended November 30, 2008, 2007 and 2006

	Common Stock		Notes Receivable for Common Stock	Retained Earnings	Total
	Shares	Amount	(In thousands)		
Balance, December 1, 2005	4,574	$ 4,187	$ (113)	$ 2,166	$ 6,240
Collection on notes receivable for common stock			8		8
Exercise of warrants	4	29			29
Net income				1,963	1,963
Balance, November 30, 2006	4,578	4,216	(105)	4,129	8,240
Collection on notes receivable for common stock			40		40
Exercise of warrants	4	34			34
Share based compensation		52			52
Net income				1,700	1,700
Balance, November 30, 2007	4,582	4,302	(65)	5,829	10,066
Collection on notes receivable for common stock			65		65
Exercise of warrants	4	34			34
Exercise of options	15	128			128
Issuance of common stock	5	50			50
Share based compensation		52			52
Net loss				(1,038)	(1,038)
Balance, November 30, 2008	4,606	$ 4,566	$	$ 4,791	$ 9,357

The accompanying notes are an integral part of these financial statements.

Table of Contents

HIRSCH ELECTRONICS CORPORATION

STATEMENTS OF CASH FLOWS
Years Ended November 30, 2008, 2007 and 2006

	2008	2007	2006
		(In thousands)	
Cash Flows from Operating Activities			
Net (loss) income	$ (1,038)	$ 1,700	$ 1,963
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities			
Depreciation and amortization	100	158	138
Change in put option derivative liability	518		
Change in allowance for doubtful accounts		(6)	(3)
Impairment on investments	360		
(Income) loss on equity method investment	(11)		20
Share based compensation	52	52	
Deferred income taxes	(261)	(66)	(120)
Loss on disposal of assets	2	5	
Change in operating assets and liabilities:			
Accounts receivable	859	(1,146)	38
Inventories	(283)	(144)	299
Prepaid expenses	(26)	1	(44)
Income taxes receivable	(1,023)	62	(62)
Accounts payable and accrued expenses	484	(87)	58
Royalties payable to related parties	(41)	35	22
Income taxes payable	(345)	291	(827)
Other accrued liabilities	447	79	(52)
Deferred revenue	(47)	115	
Net cash (used in) provided by operating activities	(253)	1,049	1,430
Cash Flows from Investing Activities			
Acquisition of property and equipment	(105)	(139)	(62)
Acquisition of investments			(367)
Note receivable			(54)
Patent costs	(1)	(1)	(10)
Net cash used in investing activities	(106)	(140)	(493)
Cash Flows from Financing Activities			
Proceeds from exercise of stock options and warrants	162	34	29
Proceeds from issuance of common stock	50		
Collection of notes receivable for common stock	65	40	8
Net cash provided by financing activities	277	74	37

Net (decrease) increase in cash	(82)	983	974
Cash and cash equivalents beginning of year	5,014	4,031	3,057
Cash and cash equivalents end of year	$ 4,932	$ 5,014	$ 4,031
Supplemental disclosure of cash flow information :			
Cash paid during the year for income taxes	$ 1,115	$ 705	$ 1,029

The accompanying notes are an integral part of these financial statements.

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
November 30, 2008, 2007 and 2006

1. ORGANIZATION

Hirsch Electronics Corporation (the Company) was incorporated in 1981 and is engaged in the design, manufacture and distribution of security management systems. The Company sells primarily to dealers located in North America.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The summary of significant accounting policies presented below is designed to assist in understanding the Company s financial statements. Such financial statements and accompanying notes are the representations of the Company s management, who are responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America (GAAP) in all material respects, and have been consistently applied in preparing the accompanying financial statements.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates made by management, among others, relate to the realizable value of inventories, the realization of long-lived assets, the allowance for doubtful accounts, the valuation of investments, the valuation of call and put options related to Hirsch EMEA, assumptions used in measuring stock-based compensation, and the valuation of deferred tax assets. While actual results could differ from those estimates, management believes that the estimates are reasonable.

Concentration of Credit Risk

The Company s financial instruments that potentially expose the Company to a concentration of credit risk consist of cash and accounts receivable. The Company places its cash with high credit quality institutions, with the majority of its cash in treasury money market funds.

From time to time, the Company maintains cash balances at certain institutions in excess of the Federal Deposit Insurance Corporation (FDIC) limit of $250,000 ($100,000 in 2007 and 2006). Such excess totaled approximately $0.2 million , $0.3 million and $0.2 million at November 30, 2008, 2007 and 2006, respectively.

The Company s sales are concentrated in a relatively few number of customers and, as a result, the Company maintains individually significant receivable balances with these parties. The Company performs periodic evaluations of its customers financial condition, but generally does not require collateral to support credit sales. The Company maintains reserves for estimated potential credit losses. Accounts receivable from one customer represented approximately 12%, and 22% of total accounts receivable at November 30, 2008 and 2007, respectively. Accounts receivable from two customers represented 25% of total accounts receivable at November 30, 2006. Sales from one customer represented approximately 12% and 15% for the years ended November 30, 2007 and 2006, respectively. There was no significant concentration of sales for the year ended November 30, 2008.

Cash and Cash Equivalents

The Company considers all liquid short-term investments, with maturity dates of three months or less when purchased, to be cash equivalents. The Company s cash equivalents consist primarily of amounts held in treasury money market funds, with a maturity of less than three months at the date of purchase. Amounts held primarily in treasury money market funds totaled approximately $4.7 million, $4.9 million and $3.6 million at November 30, 2008, 2007 and 2006, respectively.

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses approximate their fair values because of the short-term maturity of these items.

Allowance for Doubtful Accounts

The Company performs periodic reviews of collectability and provides an allowance for doubtful accounts receivable as management deems necessary. Management considers historical customer experience and industry trends in establishing and maintaining such reserve. Management considers the allowance for doubtful accounts at November 30, 2008, 2007 and 2006 of approximately $9,000, $9,000 and $15,000, respectively, to be adequate to provide for losses which could be sustained in the realization of these accounts. Although the Company expects to collect net amounts due, actual collections may differ from these estimated amounts.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market, and consist primarily of raw materials, work-in-process and finished goods. Market is determined by comparison with recent sales or net realizable value. Such net realizable value is based on management s forecasts for sales of the Company s products in the ensuing years. The Company operates in an industry characterized by technological change. Should the demand for the Company s products prove to be significantly less than anticipated, the ultimate realizable value of the Company s inventory could be substantially less than amounts in the accompanying balance sheets. The Company periodically reviews the age and turnover of its inventory to determine whether any inventory has become obsolete or has declined in value and records a charge to cost of revenues for known and estimated inventory obsolescence. There was no inventory reserve at November 30, 2008, 2007 and 2006, respectively

Investments

The Company s investments consist of cost and equity method investments in other entities. The equity method of accounting is used when the Company has the ability to exercise significant influence in the operating and financial activities of an investee. Significant influence is generally achieved by owning at least 20% of the voting interest of the investee without the ability to exercise control. Under the equity method, original investments are recorded at cost and adjusted by the Company s share of undistributed earnings or losses of these entities. Nonmarketable investments in which the Company has less than a 20% interest and in which it does not have the ability to exercise significant influence over the investee are initially carried at cost, as management believes it is not practicable to estimate fair value of this investment. An impairment charge is recognized on both equity method and cost method investments when factors indicate that a decrease in value of the investment has occurred which is other than temporary.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets ranging from five to seven years. Leasehold improvements are amortized on a straight-line basis over the lesser of the estimated useful lives of the assets or the related lease terms. Significant renewals and betterments are capitalized. Maintenance and repairs are charged to expense as incurred.

Patents

Patents represent external legal costs incurred for filing patent applications and their maintenance, and purchased patents. Amortization for patents is recorded using the straight-line method over the lesser of the life of the patent or its estimated useful life, which ranges from two to seventeen years. Accumulated amortization for

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

patents was $1.5 million, $1.5 million and $1.5 million as of November 30, 2008, 2007 and 2006, respectively. Amortization expense for patents for the years ended November 30, 2008, 2007 and 2006 was $6,960, $6,790 and $5,886, respectively. As of November 30, 2008, the estimated total amortization expense for the next five years is approximately $6,000 per year. The weighted average remaining life of the patents is approximately six years.

Long-Lived Assets

Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the cost basis of a long-lived asset is greater than the projected future undiscounted net cash flows from such asset, an impairment charge is recognized. Impairment charges are calculated as the difference between the cost basis of an asset and its estimated fair value.

Management believes that no indicators of impairment existed as of and for the year ended November 30, 2008. There can be no assurance, however, that market conditions or demand for the Company s products or services will not change which could result in long-lived asset impairment charges in the future.

Revenue Recognition

The Company derives revenue from sales of products and services. Consistently, over 90% of revenue is from sales of hardware. The following summarizes the major terms of the contractual relationships with customers and the manner in which the Company accounts for sales transactions.

Hardware Revenue

Hardware revenue consists of the sale of access control hardware including the ScramblePad products, controllers, network and communication products and other security related hardware. The Company recognizes revenue pursuant to EITF 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21) and Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements* (SAB 104). In accordance with these revenue recognition guidelines, revenue is recognized for a unit of accounting when all of the following criteria are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- fee is fixed or determinable; and
- collectability is reasonably assured.

Generally, product sales are not contingent upon customer testing, approval and/or acceptance. Professional services revenue is not recognized until the services have been performed, while product revenue is recognized at time of shipment as shipping terms are typically FOB shipping point, as the services do not affect the functionality of the delivered items.

Product returns have historically been insignificant and as such are recorded when incurred.

Software Revenue

The Company sells various software products ranging from software that is embedded in the hardware to add-on software that can be sold on a stand-alone basis. Software that is embedded in the hardware (ie   firmware   ) provides a user-interface and facilitates the functionality of the hardware. This software cannot be sold on a stand-

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

alone basis and is not a significant part of sales or marketing efforts. This embedded software is considered incidental to the hardware and is not recognized as a separate unit of accounting apart from the hardware.

The Company also sells proprietary application software that is sold as add-on software to their security hardware configurations. This provides additional functionality to the security system, such as integration of security access monitoring. Based on the factors described in footnote two of AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2) the Company considers this type of software to be more-than-incidental to the hardware components in an arrangement. This assessment is based on the fact that the software can be sold on a stand-alone basis. Software products that are considered more-than-incidental are treated as a separate unit of accounting apart from the hardware and the related software product revenue is recognized upon delivery to the customer. The Company accounts for software that is more-than-incidental in accordance with SOP 97-2 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, except collectability must be deemed probable under

SOP 97-2 versus reasonably assured under SAB 104. The Company also considers EITF 03-05, *Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software* (EITF 03-05). Per EITF 03-05, if the software is considered not essential to the functionality of the hardware, then the hardware is not considered software related and is excluded from the scope of SOP 97-2. All proprietary application software sold by the Company is not essential to the functionality of the security hardware. The hardware is not dependent upon these proprietary software products to function and the customer can fully utilize the hardware product without any of the software products. Therefore, in multiple-element arrangements containing hardware and software, the hardware elements are excluded from SOP 97-2 and are accounted for in accordance with EITF 00-21 and SAB 104 at its relative fair value as there is objective and reliable evidence of fair value for all units of accounting in these transactions.

Service Revenue

Service revenue is generated from the sale of professional services and maintenance contracts. The following describes how the Company accounts for service transactions, provided all the other revenue recognition criteria noted above have been met. Generally, services revenue, which includes maintenance contracts, security system integration services, system migration and database conversion services, is 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 and software maintenance contracts. These contracts are generally for terms. Maintenance revenue is recorded as deferred revenue and is recognized as revenue ratably over the term of the related agreement.

Multiple Element Arrangements

The Company considers sales contracts that include a combination of systems, software or services to be multiple element arrangements. Revenue related to multiple element arrangements is separated in accordance with EITF 00-21 and SOP 97-2 based on the relative fair value method. Discounts are allocated only to the delivered elements. Fair values are determined by examining the prices charged for when the elements are sold separately. Undelivered elements generally include maintenance contract revenue as other professional services are typically sold separately from the hardware sales.

Advertising

The Company expenses advertising costs as incurred. During the years ended November 30, 2008, 2007 and 2006, the Company incurred and expensed approximately $0.5 million, $0.5 million and $0.4 million in advertising expenses, respectively, which are included in selling, general and administrative expenses in the accompanying statements of operations.

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Research and Development

Research and development expenses which consist primarily of outsourced labor, salaries for personnel and materials are expensed as incurred.

Warranty

The Company offers a warranty on its products for a period of two years. Historically, warranty expenses have been insignificant and as warranty expenses are recorded when incurred.

Shipping and Handling

Costs incurred for shipping and handling are included in costs of revenue in the accompanying statements of operations. During the years ended November 30, 2008, 2007 and 2006, shipping and handling expenses were approximately $0.4 million, $0.3 million and $0.2 million, respectively.

Income Taxes

Income taxes are accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes*, using the liability method. Under this method, the Company provides for deferred income taxes to reflect the tax consequences in future years for the differences between the amounts of assets and liabilities recognized for financial reporting purposes and such amounts recognized for tax purposes using enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is provided to reduce net deferred tax assets to amounts that are more likely than not to be realized.

Stock-Based Compensation

Beginning December 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment*. This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*. SFAS No. 123(R) focuses primarily on the accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires stock-based compensation cost to be measured at the grant date, based on the fair value of the award and is recognized as expense over the employee s requisite service period (generally the vesting period). The Company has elected the prospective transition method as permitted by SFAS No. 123(R) and, accordingly, previously issued financial statements have not been restated as a result of adoption of SFAS No. 123(R). Under the prospective method, compensation cost is recognized beginning with the effective date (December 1, 2006) (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted or modified after the effective date and (b) based on the requirements of APB 25, *Accounting for Stock Issued to Employees*, for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date. All awards granted, modified, or settled after the date of adoption are accounted for using the measurement, recognition, and attribution provisions of SFAS 123(R).

The Company has two stock-based employee compensation plans. Prior to December 1, 2006, the Company accounted for those plans under the recognition and measurement principles of APB No. 25, and related interpretations. No stock-based employee compensation cost was reflected in the accompanying statements of operations for the year ended November 30, 2006, as all options granted under those plans had an exercise price equal to or greater than the estimated fair market value of the underlying common stock on the date of grant. The

Table of Contents

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

following table illustrates the effect on net income as if the Company had applied the fair value recognition provisions of SFAS No. 123 for its stock-based employee compensation plans as of November 30, 2006:

	(In thousands)
Net income, as reported	$ 1,963
Stock-based compensation, net of tax	(32)
Net income, pro forma	$ 1,931

For purposes of computing the pro forma amount, the fair value of stock-based compensation was estimated using a Black-Scholes option pricing model with the assumptions of a weighted-average expected life of 10 years, no annual dividend per share, risk free interest rate of 4.78%, and no volatility (minimum value method).

Recent Accounting Pronouncements

Fair Value Measurement

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurement*. SFAS No. 157 provides a framework that clarifies the fair value measurement objective within GAAP and its application under the various accounting standards where fair value measurement is allowed or required. Under SFAS No. 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. However, in February 2008, FASB Staff Position, or FSP, No. 157-b, *Effective Date of Statement 157*, was issued which delayed the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The FSP partially defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008.

Effective December 1, 2007, the Company adopted SFAS No. 157 except as it applies to those nonfinancial assets and nonfinancial liabilities within the scope of FSP No. 157-b. The partial adoption of SFAS No. 157 did not have a material impact on the Company s financial position and results of operations. The Company is currently assessing the impact of the adoption of SFAS No. 157 as it relates to nonfinancial assets and nonfinancial liabilities and has not yet determined the impact that the adoption will have on its financial position and results of operations.

In October 2008, the FASB issued FSP, No. FAS 157-3, *Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active* to clarify the application of the provisions of SFAS 157 in an inactive market and how an entity would determine fair value in an inactive market. FSP 157-3 is effective immediately and applies to our

November 30, 2008 financial statements. The application of the provisions of FSP 157-3 did not materially impact the Company s financial statements.

Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, *Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 provides an option to report selected financial assets and liabilities at fair value. GAAP has required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. SFAS No. 159 attempts to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS No. 159 also establishes presentation and disclosure requirements

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company has elected not to exercise the option to report selected financial assets and liabilities at fair value as provided for under SFAS No. 159, accordingly, there is no impact on the Company s financial position and results of operations.

Accounting for Uncertainty in Income Taxes

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN No. 48). This interpretation clarified the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109. Specifically, FIN No. 48 clarifies the application of SFAS No. 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise s financial statements. Additionally, FIN No. 48 provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods of income taxes, as well as the required disclosure and transition. FIN 48 specifies that the evaluation of the tax position is a two-step process: 1) Recognition: determining whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation process, and 2) Measurement: a tax position that meets the more-likely-than-not recognition threshold is measured to determine that amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefits that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority. This interpretation is effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle to be recorded as an adjustment to the beginning balance of retained earnings. However, in February 2008, FSP No. FIN 48-2 was issued to delay the effective date of FIN No. 48 for certain nonpublic enterprises to the annual financial statements for fiscal years beginning after December 15, 2007, (applied as of the beginning of the enterprise s fiscal year). The Company is currently evaluating the requirements of FIN No. 48 and has not yet determined if the adoption of FIN No. 48 will have a significant impact on the Company s financial statements.

Business Combinations

In December 2007, the FASB issued Statement No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)). This statement improves the financial reporting of business combinations and clarifies the accounting for these transactions. SFAS No. 141(R) (i) requires the recognition and measurement of assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at their fair values at the acquisition date, (ii) requires acquisition costs and any related restructuring costs to be recognized separately from the acquisition, (iii) requires step acquisitions to be recognized at the full amounts of the fair values of the identifiable assets and liabilities, as well as any noncontrolling interest in the acquiree, (iv) changes the requirements for recognizing assets acquired and liabilities assumed arising from contingencies, (v) defines a bargain purchase as a business combination in which the total acquisition-date fair value of the identifiable net assets exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, (vi) requires the recognition of any bargain purchase as a gain in the earnings of the acquirer, and (vii) requires the recognition of changes in deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination or directly in the contributed capital, depending upon the circumstances. In addition, acquired in-process research and development, or IPR&D, is capitalized as an intangible asset and amortized over its estimated useful life. The provisions of SFAS No. 141(R) are to be applied prospectively to business combinations with acquisition dates on or after the beginning of an entity s fiscal year that begins on or after December 15, 2008, with early adoption prohibited. The adoption of SFAS No. 141(R) will change our accounting treatment for business combinations on a prospective basis beginning December 1, 2009. The Company is currently assessing SFAS No. 141R and has not yet determined the impact that the adoption will have on its financial position and results of operations.

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Useful Life of Intangible Assets

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The Company is required to adopt FSP No. FAS 142-3 effective at the beginning of 2010. The adoption of FSP No. FAS 142-3 is not expected to have a material impact on the Company s financial statements.

Other recent accounting pronouncements issued by the FASB and the AICPA did not or are not believed by management to have a material impact on the Company s present or future financial statements.

Reclassifications

Certain reclassifications have been made to prior year balances in order to conform to the current year s presentation.

3. FAIR VALUE

SFAS No. 157 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which the Company would transact and considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance.

Fair Value Hierarchy

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs 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 in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Company measures financial assets at fair value on a recurring basis. The Company s investments in money market funds are measured at fair value on a recurring basis. The Company s money market funds are required to be priced and have a fair value of $1.00 net asset value per share. These money market funds are actively traded and reported daily through a variety of sources. These funds have a credit rating of A. Since they are actively traded, the fair value of the money market fund investments has been classified as level 1.

In 2006, the Company purchased 25% of the outstanding stock in Hirsch EMEA (EMEA). The stock purchase agreement included a call option and a put option to purchase the remaining outstanding shares of EMEA at a price of 1,000,000 Euro and become exercisable contingent on a change in control of the Company. EMEA is a privately held company with no level 1 or 2 inputs to measure fair value. As such, the options were valued using the

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Black-Scholes American option model with a term of 10 years. The risk free rate was 2.92%, 3.94%, and 4.46% at November 30, 2008, 2007, and 2006, respectively. The probability of change of control was 45%, 10%, and 5% at November 30, 2008, 2007, and 2006, respectively. At November 30, 2008, the put option was valued at approximately $518,000, and this amount was recorded as a liability on the balance sheet and a corresponding charge taken on the statement of operations. The put option values were not material for the fiscal years 2007 and 2006 and therefore were not recorded in the financial statements at November 30, 2007 and 2006. The call option values for were not material for fiscal years 2008, 2007 and 2006 and therefore were not recorded in the financial statements at November 30, 2008, 2007, and 2006.

There were no movements between level 1 and level 3 classes of measurements for the years ended November 30, 2008, 2007, and 2006.

4. INVENTORIES

Inventories consisted of the following as of November 30:

	2008	2007	2006
		(In thousands)	
Raw materials	$ 773	$ 676	$ 519
Work-in-process	259	293	376
Finished goods	839	618	549
	$ 1,871	$ 1,587	$ 1,444

5. NOTE RECEIVABLE

As of November 30, 2008 and 2007, the Company has a note receivable from Bridgepoint Systems, Inc (Bridgepoint) for $54,500 that carried interest at an annual rate of 9%. The note matured on November 30, 2007. The Company had an option to convert the principal and accrued interest at maturity date to Bridgepoint common stock at a price of $0.50 per share. Management is currently in the process of negotiating terms on the note and believes that the carrying amount of the note was not impaired at November 30, 2008.

6. INVESTMENTS

During fiscal 2005, the Company purchased an investment consisting of equity securities in Pindi Products, Inc. (Pindi), a privately held developer of biometric technology. Management believes that the carrying amount (on the cost method) of $0.1 million was impaired at November 30, 2008 and recorded an impairment charge during the year ended November 30, 2008 which is included in other (loss) income in the accompanying statements of operations (see Note 10).

In May 2006, the Company invested approximately $0.4 million to purchase a 25% interest in Hirsch EMEA (EMEA), a privately held company located in Europe. EMEA owns 95% of the outstanding stock of MCV Trading, an Italian subsidiary (MCV), which operates and distributes security systems and equipment in Europe, the Middle East and Asia. The stock purchase agreement included a call option and a put option to purchase the remaining outstanding shares of EMEA at a price of 1,000,000 Euro and become exercisable contingent on a change in control of the Company (see Note 3). The Company s President is a board member of EMEA. At the purchase date, the Company s investment exceeded the net book value of EMEA s equity by $0.3 million.

As of August 31, 2008, the Company determined that the investment in EMEA had experienced an other than temporary decline in value, and recorded an impairment charge of $0.3 million, which is included in other (loss) income in the accompanying statements of operations (see Note 10). For the three months ended November 30, 2008, the Company recorded a gain of $11,500, representing the Company s proportionate share of EMEA s

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

undistributed net income for the three months ended November 30, 2008, which is included in other (loss) income in the accompanying statements of operations (see Note 10).

During the years ended November 30 2008, 2007 and 2006, the Company had sales of approximately $0.2 million, $0.1 million and $0.1 million, respectively, to MCV. As of November 30, 2008, 2007 and 2006, the Company had receivables of approximately $0.1 million, $43,000 and $5,000, respectively, which is included in accounts receivable in the accompanying balance sheet.

During fiscal 2008, 2007, and 2006, the Company paid commissions to EMEA of approximately $0.1 million, $0.1 million, and $0.1 million, respectively, for the European sales of the Company s products.

7. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following as of November 30:

	2008	2007	2006
		(In thousands)	
Computer hardware and software	$ 463	$ 390	$ 435
Machinery and equipment	308	308	242
Office equipment	241	238	237
Furniture and fixtures	112	112	114
Leasehold improvements	349	349	349
	1,473	1,397	1,377
Accumulated depreciation and amortization	(1,211)	(1,143)	(1,106)
	$ 262	$ 254	$ 271

8. OTHER ACCRUED LIABILITIES

Other accrued liabilities consisted of the following as of November 30:

	2008	2007	2006
		(In thousands)	
Accrued bonuses	$ 165	$ 214	$ 87
Deferred rent	35		44
Accrued research and development and acquisition expenses	458		
Other	106	103	107

$ 764	$ 317	$ 238

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

9. INCOME TAXES

The provision for income tax (benefit) expense consisted of the following as of November 30:

	2008	2007	2006
		(In thousands)	
Current:			
Federal	$ (360)	$ 959	$ 1,003
State	(43)	256	208
	(403)	1,215	1,211
Deferred:			
Federal	(243)	(56)	(107)
State	(18)	(10)	(13)
	(261)	(66)	(120)
	$ (664)	$ 1,149	$ 1,091

Differences between the U.S. federal statutory income tax rates and the effective tax rates are as follows for the years ended November 30:

	2008	2007	2006
Tax at U.S. federal statutory rates	(34.00)%	34.00%	34.00%
State taxes, net of federal benefit	(5.91)	5.61	3.54
Permanent differences	.72	.74	.59
Credits	(4.05)	(.45)	(.62)
Tax contingency reserve	1.72		
Other	2.43	.42	(1.78)%
Provision for income tax (benefit) expense	(39.09)%	40.32%	35.73%

The components of deferred income taxes were as follows as of November 30:

	2008	2007	2006
		(In thousands)	

Depreciation	$ 39	$ 37	$ 15
Reserves	29	4	6
Loss on EMEA	132	8	
Change in put option derivative liability	226		
FAS 123(R)	9	21	
Effect on state taxes		86	87
Deferred revenue		18	
Total deferred tax asset	$ 435	$ 174	$ 108

Table of Contents

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

10. OTHER INCOME (EXPENSE)

Other income (expense) includes the following non-operating items for the years ended November 30:

	2008	2007	2006
	(In thousands)		
Income (loss) on equity method investment	$ 11	$	$ (20)
Loss on investments	(360)		
Change in put option derivative liability	(518)		
Interest income	125	216	159
Total other income (expense)	$ (742)	$ 216	$ 139

11. COMMON STOCK PLANS

1997 Incentive Stock Plan

The 1997 Incentive Stock Plan (the 1997 Plan) provides for the grant of options to employees to purchase shares of the Company s common stock. The 1997 Plan includes ISOs for which the option price will not be less than the estimated fair market value of the shares of the Company s common stock on the date of the grant. Such fair values are determined on the date of grant based on an expected life of 10 years, a risk-free interest rate, a volatility based on a blended rate of several quoted public market prices for the common stock of several publicly-traded companies who are major providers and serve a similar market as the Company, and no dividend yield. Options expire within a period of not more than ten years from the date of the grant. Options vest over 4 to 5 years from the date of issuance. The 1997 Plan provides for the issuance of up to 100,000 shares of common stock. As of November 30, 2007, there were 10,000 shares available for issuance under the 1997 Plan.

In February 2006, the Company granted options to purchase a total of 10,000 shares of common stock to an employee. The stock options have an exercise price of $9.50 (estimated by management to be the fair market value of the stock), and were vested immediately upon issuance. Such stock options expire ten years from the date of grant.

	Number of Shares	Weighted-Average Exercise Price
Options outstanding at December 1, 2005	85,000	$ 8.38
Exercised		
Granted	10,000	$ 9.50
Expired	(5,000)	$ 8.00
Options outstanding at November 30, 2006	90,000	$ 8.53

Exercised			
Granted			
Expired			
Options outstanding at November 30, 2007	90,000	$	8.53
Exercised	15,000	$	8.50
Granted			
Expired			
Options outstanding and exercisable at November 30, 2008	75,000	$	8.53

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

The number of outstanding and exercisable options under the 1997 Plan as of November 30, 2008 is provided below:

	Outstanding			Exercisable		
Range of Exercise Prices	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
$8.00	40,000	$8.00	4.49	40,000	$8.00	4.49
$9.00	25,000	$9.00	0.38	25,000	$9.00	0.38
$9.50	10,000	$9.50	7.18	10,000	$9.50	7.18
	75,000			75,000		

Warrants

From time to time, the Company may grant warrants to third party service providers or directors.

During the years ended November 30, 2007 and 2006, the Company granted warrants to directors to purchase 12,000 and 6,000 shares of the Company s common stock at an exercise price of $10.00 and $9.50 per share, respectively (estimated by management to be the fair market value of the stock). The warrants vested upon issuance and expire ten years from the date of grant. There were no warrants granted during the year ended November 30, 2008.

In connection with the adoption of SFAS No. 123(R) during the year ended November 30, 2007, the Company recorded stock-based compensation expense totaling $0.1 million associated with warrants to purchase 12,000 shares of the Company s common stock granted during 2007. An additional $0.1 million of stock-based compensation expense was recorded during the November 30, 2008. The fair value of the 2007 warrant grants amounted to $8.63 using the Black-Scholes option-pricing model. Such fair value was determined on the date of grant based on an expected life of 10 years, a risk-free interest rate of 5.20%, a volatility of 84.9% based on a blended rate of quoted public market prices for the common stock of several publicly-traded companies who are major providers and serve a similar market as the Company, and no dividend yield. The expense related to warrants was included in the Selling, General and administration line in the statement of operations for the year ended November 30, 2008 and 2007.

During each of the years ended November 30, 2008, 2007 and 2006, the Company issued 4,000 shares of common stock pursuant to the exercise of stock warrants for cash proceeds of $34,000, $34,000 and $29,000, respectively.

	Number of Shares	Weighted-Average Exercise Price
Warrants outstanding and exercisable at December 1, 2005	44,000	$ 8.45
Granted	6,000	$ 9.50
Exercised	(4,000)	$ 7.25

Warrants outstanding and exercisable at November 30, 2006	46,000	$	8.70
Granted	12,000	$	10.00
Exercised	(4,000)	$	8.50
Warrants outstanding and exercisable at November 30, 2007	54,000	$	9.00
Granted			
Exercised	(4,000)	$	8.50
Warrants outstanding and exercisable at November 30, 2008	50,000	$	9.04

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

The number of outstanding and exercisable warrants as of November 30, 2008 is provided below:

	Outstanding and Exercisable		
Range of Exercise Prices	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
$ 8.00 to $ 8.50	18,000	$8.00	4.09
$ 9.00 to $ 9.50	20,000	$9.40	4.56
$10.00 to $10.50	12,000	$10.00	9.27
	50,000		

Notes Receivable for Common Stock

Included in stockholders equity as of November 30, 2007 and 2006 are two notes receivable from stockholders. One note has annual interest at the prime rate (7.5% at November 30, 2007), was payable to the Company on demand and was paid in full during the year ended November 30, 2008. The note was issued as consideration for 10,000 shares of the Company s common stock. The other note had an annual interest rate of prime rate (8.25% at November 30, 2006) plus 2% and was paid in full during the year ended November 30, 2007. The note was issued as consideration for 17,415 shares of the Company s common stock. During the years ended November 30, 2008, 2007 and 2006, the Company collected $0.1 million, $40,000 and $8,000, respectively, of principal on the notes.

12. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases its facilities under operating leases with expiration dates through fiscal 2012. In November 2007, the Company exercised its five-year option to renew its seven-year noncancelable building lease commencing December 1, 2007. This lease also includes a scheduled base rent increase of 3.0% per year over the term of the lease. At November 30, 2008 and 2006, deferred rent expense totaled approximately $35,000 and $44,000, respectively and is included in other accrued liabilities in the accompanying balance sheet. There was no deferred rent expense at November 30, 2007. Rent expense under the operating leases was approximately $0.5 million, $0.4 million and $0.4 million for the years ended November 30, 2008, 2007 and 2006, respectively.

At November 30, 2008, future minimum lease payments under noncancelable operating leases are as follows for the fiscal years ending November 30:

	(In thousands)
2009	$ 487

2010		469
2011		472
2012		486
Total minimum lease payments	$	1,914

Merger Termination

The Company entered into an Agreement and Plan of Merger with SCM Microsystems, Inc. (SCM). Under certain circumstances Hirsch may be required to pay SCM a termination fee of $1.5 million, plus an amount equal to all out-of-pocket expenses (excluding the cost of employee time) incurred by SCM in connection with the merger agreement, the ancillary agreements, and the merger.

Table of Contents

HIRSCH ELECTRONICS CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Legal Matters

From time to time, claims are made against the Company in the ordinary course of business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting the Company from selling one or more products or engaging in other activities. The occurrence of an unfavorable outcome in any specific period could have a material adverse effect on the Company s results of operations for that period or future periods. The Company is not presently a party to any pending or threatened legal proceedings.

13. BENEFIT PLAN

The Company has a 401(k) plan that covers substantially all employees. Employer contributions to the plan are made at the discretion of the Board of Directors. The Company made no contributions for the years ended November 30, 2008, 2007 and 2006. The Company paid administrative expenses on behalf of the plan of approximately $5,000 for each of the years ended November 30, 2008, 2007 and 2006.

14. ROYALTY AGREEMENT AND RELATED PARTY TRANSACTIONS

Effective November 1994, the Company entered into a settlement agreement with two limited partnerships, Secure Keyboards, Ltd. (Keyboards) and Secure Networks, Ltd. (Networks), which are related to the Company through certain common shareholders and limited partners, including the Company s President, who owns 14% of the Company, 30% of Keyboards, and 9% of Networks. Under the terms of a previous agreement, the Company purchased the exclusive rights to certain patents and technology from Keyboards and Networks.

Under the terms of the settlement agreement, the Company has agreed to pay a royalty of 4.25% to Keyboards for the period from December 1, 1994 to December 31, 2020 and 5.5% to Networks for the period from December 1, 1994 to December 31, 2011, based on an allocation of revenues recognized by the Company starting at 55% and 45% of the Company s revenues for Keyboards and Networks, respectively. The royalty is payable when cash is received for the revenue recognized. The overall allocation of revenues recognized, upon which the respective royalty is calculated, will increase by 2.08% annually for Keyboards and decrease by 2.08% annually for Networks through December 31, 2011. No royalties will be payable to Networks for revenues recognized after December 31, 2011. The final payment to Networks is due on January 30, 2012. From January 1, 2012 to December 31, 2020, the royalty to Keyboards will be based on 4.25% of all revenues recognized by the Company. The final royalty payment to Keyboards is due on January 30, 2021.

During the years ended November 30, 2008, 2007 and 2006, the Company paid approximately $1.0 million, $1.0 million and $0.9 million, respectively, in royalties to Keyboards and Networks combined. At November 30, 2008, 2007 and 2006, the Company had a royalty payable of approximately $0.3 million, $0.4 million and $0.4 million, respectively, to Keyboards and Networks combined.

15. SUBSEQUENT EVENTS

On December 10, 2008, the Company entered into an Agreement and Plan of Merger with SCM Microsystems, Inc. For each of the Hirsch shares outstanding, at the effective time of the Merger Hirsch stockholders will receive $3.00 cash, two shares of SCM common stock, and a warrant to purchase one share of SCM common stock at an exercise of $3.00. At the effective time, the Merger Agreement also provides that outstanding warrants to purchase shares of Hirsch common stock will be converted into warrants to acquire shares of SCM s Common Stock, and outstanding options to purchase shares of Hirsch common stock will be cancelled. The completion of the merger is contingent upon customary conditions of closing, including regulatory clearances and the approval of the stockholders of both companies. The merger is expected to close during the Company s 2009 fiscal year.

In December 2008, Hirsch entered into an agreement with the remaining shareholders representing 71% ownership of EMEA to purchase their shares for consideration of $0.5 million in cash and 100,000 shares of Hirsch common stock, making EMEA a wholly-owned subsidiary of Hirsch.

HIRSCH ELECTRONIC CORPORATION

INDEX TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Balance Sheets as of February 28, 2009 and November 30, 2008 F-73

Statements of Operations for the Three Months Ended February 28, 2009 and February, 29 2008 F-74

Statements of Cash Flows for the Three Months Ended February 28, 2009 and February 29, 2008 F-75

Notes to Condensed Consolidated Financial Statements F-76

HIRSCH ELECTRONICS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

	February 28, 2009	November 30, 2008
	(In thousands)	
	(Unaudited)	
Current Assets		
Cash and cash equivalents	$ 3,404	$ 4,932
Accounts receivable, net	3,711	3,082
Inventories	1,878	1,871
Prepaid expenses	344	281
Note receivable	54	54
Income taxes receivable	1,023	1,023
Deferred tax asset	245	245
Total current assets	10,659	11,488
Property and Equipment, net	245	262
Investments		48
Goodwill	474	
Patents, net	38	39
Deferred Tax Asset	191	191
Other Assets	39	37
Total assets	$ 11,646	$ 12,065
Current Liabilities		
Accounts payable and accrued expenses	$ 1,606	$ 1009
Royalties payable to related parties	292	349
Derivative liabilities		518
Bank-overdraft	220	
Other accrued liabilities	360	764
Deferred revenue	68	68
Total current liabilities	2,546	2,708
Commitments and Contingencies		
Stockholders Equity		
Common stock, no par value	5,348	4,566
Retained earnings	3,780	4,791
Accumulated other comprehensive income (loss)	(28)	
Total stockholders equity	9,100	9,357
Total liabilities and stockholders equity	$ 11,646	$ 12,065

See notes to condensed consolidated financial statements.

HIRSCH ELECTRONICS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended	
	February 28, 2009	February 29, 2008
	(In thousands) (Unaudited)	
Net revenues	$ 5,114	$ 5,247
Cost of revenues	2,461	2,207
Royalties to related parties	222	232
Gross profit	2,431	2,808
Operating expenses:		
Selling, general and administrative	2,555	1,971
Research and development	880	288
	3,435	2,259
(Loss) income from operations	(1,004)	549
Other (loss) income	(7)	51
(Loss) income before provisions for income taxes	(1,011)	600
Provision for income tax benefit (expense)		(240)
Net (loss) income	$ (1,011)	$ 360

See notes to condensed consolidated financial statements.

HIRSCH ELECTRONICS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended	
	February 28, 2009	February 29, 2008
	(In thousands)	
	(Unaudited)	
Cash Flows from Operating Activities		
Net (loss) income	$ (1,011)	$ 360
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities		
Depreciation and amortization	22	25
Change in operating assets and liabilities:		
Accounts receivable	12	1,271
Inventories	17	(536)
Prepaid expenses and other assets	(58)	(124)
Accounts payable and accrued expenses	426	11
Royalties payable to related parties	(57)	(31)
Income taxes payable		(225)
Other accrued liabilities	(457)	(9)
Deferred revenue		(49)
Net cash (used in) provided by operating activities	(1,106)	693
Cash Flows from Investing Activities		
Proceeds from sale of property and equipment	12	(40)
Acquisition of investments	(500)	
Net cash used in investing activities	(488)	(40)
Cash Flows from Financing Activities		
Proceeds from bank overdraft	94	
Net cash provided by financing activities	94	
Effect of exchange on cash and cash equivalents	(28)	
Net (decrease) increase in cash	(1,528)	653
Cash and cash equivalents beginning of year	4,932	5,014
Cash and cash equivalents end of year	$ 3,404	$ 5,667

See notes to condensed consolidated financial statements.

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
February 28, 2009

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization

Hirsch Electronics Corporation (the Company) was incorporated in 1981 and is engaged in the design, manufacture and distribution of security management systems. The Company sells primarily to dealers located in North America.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Hirsch EMEA, Inc. (Hirsch EMEA), a British Virgin Islands company. Hirsch EMEA comprises Hirsch EMEA, Inc. together with each of its other subsidiaries. All intercompany transactions and balances have been eliminated upon consolidation. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) that are necessary for a fair presentation of the results for and as of the periods shown. Certain information or footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the SEC. These financial statements should be read in conjunction with the financial statements and related notes for the year ended November 30, 2008 included elsewhere in this Form S-4. The preparation of unaudited condensed consolidated financial statements necessarily requires the Company 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.

On January 1, 2009, Hirsch acquired Hirsch EMEA. The results for the acquired Hirsch business are included in the Company s consolidated statements of operations since the date of acquisition on January 1, 2009. As a result of the timing of this transaction, the Company s condensed consolidated results for the periods presented are not directly comparable.

Goodwill

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. The Company evaluates 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.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 168, *The FASB Accounting Standards Codification*^{tm} *and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162,* (SFAS No. 168). SFAS No. 168 replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles,* and establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Rules and

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

interpretive releases of the Securities and Exchange Commission (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. SFAS No. 168 becomes effective for the financial statements issued for interim and annual periods ending after September 15, 2009. Management has determined that the adoption of SFAS 168 will not have an impact on the Company s financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141(R)), which replaces SFAS No. 141, *Business Combinations* (SFAS No. 141) but retains the fundamental requirements in SFAS 141, including that the purchase method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. 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. SFAS No. 141(R) will change the Company s accounting treatment for business combinations on a prospective basis. SFAS No. 160 will be effective for Hirsch on a prospective basis for business combinations with an acquisition date after December 1, 2009.

In December 2007, FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* (SFAS No. 160). 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. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. SFAS No. 160 will be effective for Hirsch on a prospective basis for business combinations with an acquisition date after December 1, 2009.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurement*. SFAS No. 157 provides a framework that clarifies the fair value measurement objective within GAAP and its application under the various accounting standards where fair value measurement is allowed or required. Under SFAS No. 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. However, in February 2008, FASB Staff Position, or FSP, No. 157-b, *Effective Date of Statement 157,* was issued which delayed the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The FSP partially defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008.

The Company adopted SFAS No. 157 for all its financial assets and financial liabilities on December 1, 2007 and adopted SFAS No. 157 as it relates to nonfinancial assets and nonfinancial liabilities within the scope of FSP No. 157-b on December 1, 2008. The adoption of SFAS No. 157 did not have a material impact on the Company s financial position and results of operations.

In October 2008, the FASB issued FSP, No. FAS 157-3, *Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active* to clarify the application of the provisions of SFAS 157 in an inactive

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

market and how an entity would determine fair value in an inactive market. FSP 157-3 was effective immediately. The application of the provisions of FSP 157-3 did not materially impact the Company s financial statements.

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The Company is required to adopt FSP No. FAS 142-3 effective at the beginning of 2010. The adoption of FSP No. FAS 142-3 is not expected to have a material impact on the Company s financial statements.

2. FAIR VALUE

SFAS No. 157 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which the Company would transact and considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance.

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs 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 in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

The Company measures financial assets at fair value on a recurring basis. The Company s investments in money market funds are measured at fair value on a recurring basis. The Company s money market funds are required to be priced and have a fair value of $1.00 net asset value per share. These money market funds are actively traded and reported daily through a variety of sources. These funds have a credit rating of A. Since they are actively traded, the fair value of the money market fund investments has been classified as level 1.

In 2006, the Company purchased 25% of the outstanding stock in Hirsch EMEA (EMEA). The stock purchase agreement included a call option and a put option to purchase the remaining outstanding shares of EMEA at a price of 1,000,000 Euro and become exercisable contingent on a change in control of the Company. EMEA is a privately held company with no level 1 or 2 inputs to measure fair value. As such, the options were valued using the Black-Scholes

American option model with a term of 10 years. The risk free rate was 2.92% at November 30, 2008. The probability of change of control was 45% at November 30, 2008. At November 30, 2008, the put option was valued at approximately $518,000, and this amount was recorded as a liability on the balance sheet and a corresponding charge taken on the statement of operations. The call option value was not material for fiscal years 2008 and therefore was not recorded in the financial statements at November 30, 2008. In December 2008, Hirsch entered into an agreement with the remaining shareholders representing 71% ownership of EMEA to purchase their shares for consideration of $0.5 million in cash and 100,000 shares of Hirsch common stock, making EMEA a wholly-owned subsidiary of Hirsch. As a result, the value of put option liability was eliminated upon acquisition. See Note 3 for discussion of this acquisition.

Non-financial assets that are measured and recognized at fair value on a non-recurring basis is Goodwill in the amount of $0.5 million which was measured using inputs at Level 3, because it was based on unobservable inputs

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

and involved management judgment and assumptions about market participants and pricing. See Note 3 for discussion of this acquisition.

As of February 28, 2009, there were no liabilities that are measured and recognized at fair value on a recurring basis.

3. ACQUISITION OF HIRSCH EMEA

In May 2006, the Company purchased a 25% interest in Hirsch EMEA (EMEA), a privately held company located in Europe. EMEA owns 95% of the outstanding stock of MCV Trading, an Italian subsidiary (MCV), which operates and distributes security systems and equipment in Europe, the Middle East and Asia. The stock purchase agreement included a call option and a put option to purchase the remaining outstanding shares of EMEA at a price of 1,000,000 Euro and become exercisable contingent on a change in control of the Company (see Note 2). The Company s President is a board member of EMEA. At November 30, 2008, the put option was valued at approximately $518,000, and this amount was recorded as a liability on the balance sheet.

In December 2008, Hirsch entered into an agreement with the remaining shareholders representing 71% ownership of EMEA to purchase their shares for consideration of $0.5 million in cash and 100,000 shares of Hirsch common stock, making EMEA a wholly-owned subsidiary of Hirsch. The following table summarizes the components of the estimated total purchase price (in thousands):

Cash paid for Hirsch EMEA common stock	$ 500
Fair value of common stock issued	782
Fair value of put option liability offset	(518)
Equity method investment	48
Total purchase price	$ 812

The fair value of the shares of Hirsch common stock issued was estimated using the estimated purchase consideration amount Hirsch would have received upon its acquisition by SCM Microsystems, Inc. (SCM), or $7.83 per share.

The acquisition was accounted for using the purchase method of accounting. The purchase price was allocated based on the estimated fair values of tangible assets acquired and liabilities assumed in the acquisition. An allocation of the purchase price was made to major categories of assets and liabilities based on management s best estimates at the date of acquisition. The excess of the purchase price over the estimated fair value of tangible assets acquired and liabilities assumed was allocated to goodwill. The total purchase price was allocated to the fair value of assets acquired and liabilities assumed as follows (in thousands):

Accounts receivable, net	641
Inventories	24
Property and equipment and other assets	23

Accounts payable		(171)
Bank overdraft		(126)
Taxes payable		(53)
Goodwill		474
Total estimated purchase price	$	812

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

4. INVENTORIES

Inventories consisted of the following:

	February 28, 2009	November 30, 2008
	(In thousands)	
Raw materials	$ 1,047	$ 773
Work-in-process	73	259
Finished goods	758	839
	$ 1,878	$ 1,871

5. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

	February 28, 2009	November 30, 2008
	(In thousands)	
Computer hardware and software	$ 467	$ 463
Machinery and equipment	308	308
Office equipment	241	241
Furniture and fixtures	112	112
Leasehold improvements	349	349
	1,477	1,473
Accumulated depreciation and amortization	(1,232)	(1,211)
	$ 245	$ 262

6. GOODWILL

During the three months ended February 28, 2009, the Company recorded goodwill in connection with the Company s acquisition of Hirsch EMEA of $0.5 million.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142), the Company tests its goodwill annually for impairment and assesses whether there are any indicators of impairment on an interim basis. Management did not identify any impairment indicators during the three months ended February 28, 2009.

7. OTHER ACCRUED LIABILITIES

Other accrued liabilities consisted of the following:

	February 28, 2009	November 30, 2008
	(In thousands)	
Accrued bonuses	$ 146	$ 165
Deferred rent	36	35
Accrued research and development and acquisition expenses	42	458
Other	136	106
	$ 360	$ 764

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

8. COMMON STOCK PLANS

1997 Incentive Stock Plan

The 1997 Incentive Stock Plan (the 1997 Plan) provides for the grant of options to employees to purchase shares of the Company s common stock. The 1997 Plan includes ISOs for which the option price will not be less than the estimated fair market value of the shares of the Company s common stock on the date of the grant. Such fair values are determined on the date of grant based on an expected life of 10 years, a risk-free interest rate, a volatility based on a blended rate of several quoted public market prices for the common stock of several publicly-traded companies who are major providers and serve a similar market as the Company, and no dividend yield. Options expire within a period of not more than ten years from the date of the grant. Options vest over 4 to 5 years from the date of issuance. The 1997 Plan provides for the issuance of up to 100,000 shares of common stock. As of November 30, 2008, all the shares were issued under the 1997 Plan.

	Number of Shares	Weighted-Average Exercise Price
Options outstanding at November 30, 2007	90,000	$ 8.53
Exercised	15,000	$ 8.50
Granted		
Expired		
Options outstanding at November 30, 2008	75,000	$ 8.53
Exercised		
Granted		
Expired		
Options outstanding and exercisable at February 28, 2009	75,000	$ 8.53

The number of outstanding and exercisable options under the 1997 Plan as of February 28, 2009 is provided below:

	Outstanding			Exercisable		
Range of Exercise Prices	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
$ 8.00	40,000	$ 8.00	4.49	40,000	$ 8.00	4.49

$	9.00	25,000	$	9.00	0.38	25,000	$	9.00	0.38
$	9.50	10,000	$	9.50	7.18	10,000	$	9.50	7.18
		75,000				75,000			

Warrants

From time to time, the Company may grant warrants to third party service providers or directors. There were no warrants granted during the year ended November 30, 2008. No stock-based compensation expense was recognized in the consolidated statement of operations in connection with the adoption of SFAS No. 123(R) during the three months ending February 28, 2009 and February 29, 2008.

During the year ended November 30, 2008, the Company issued 4,000 shares of common stock pursuant to the exercise of stock warrants for cash proceeds of $34,000.

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

	Number of Shares	Weighted-Average Exercise Price
Warrants outstanding and exercisable at November 30, 2007	54,000	$ 9.00
Granted		
Exercised	(4,000)	$ 8.50
Warrants outstanding and exercisable at November 30, 2008	50,000	$ 9.04
Granted		
Exercised		
Warrants outstanding and exercisable at February 28, 2009	50,000	$ 9.04

The number of outstanding and exercisable warrants as of February 28, 2009 is provided below:

	Outstanding and Exercisable		
Range of Exercise Prices	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
$8.00 to $8.50	18,000	$ 8.00	4.09
$9.00 to $9.50	20,000	$ 9.40	4.56
$10.00 to $10.50	12,000	$ 10.00	9.27
	50,000		

9. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases its facilities under operating leases with expiration dates through fiscal 2012. In November 2007, the Company exercised its five-year option to renew its seven-year noncancelable building lease commencing December 1, 2007. This lease also includes a scheduled base rent increase of 3.0% per year over the term of the lease. At February 28, 2009 and November 30, 2008, deferred rent expense totaled approximately $36,000 and $35,000, respectively and is included in other accrued liabilities in the accompanying balance sheet. Rent expense under the operating leases was approximately $0.1 million and $0.1 million for the three months ended February 28, 2009 and February 29, 2008, respectively.

At February 28, 2009, future minimum lease payments under noncancelable operating leases are as follows for the periods ending November 30:

	(In thousands)
9 months ending 2009	$ 364
2010	469
2011	472
2012	486
Total minimum lease payments	$ 1,791

Merger Termination

The Company entered into an Agreement and Plan of Merger with SCM Microsystems, Inc. (SCM). Under certain circumstances Hirsch may be required to pay SCM a termination fee of $1.5 million, plus an amount equal to all out-of-pocket expenses (excluding the cost of employee time) incurred by SCM in connection with the merger agreement, the ancillary agreements, and the merger.

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
February 28, 2009

Legal Matters

From time to time, claims are made against the Company in the ordinary course of business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting the Company from selling one or more products or engaging in other activities. The occurrence of an unfavorable outcome in any specific period could have a material adverse effect on the Company s results of operations for that period or future periods. The Company is not presently a party to any pending or threatened legal proceedings.

On March 18, 2009, Secure Keyboards and two of its general partners, Luis Villalobos and Howard B. Miller, filed suit in Los Angeles Superior Court against us and Felix Marx, SCM Chief Executive Officer. The plaintiffs alleged multiple causes of action, including interference with contract in connection with the then prospective acquisition of Hirsch by SCM and a 1994 Settlement Agreement entered into by and among Secure Keyboards, Hirsch and Secure Networks, Ltd., and sought damages, including approximately $20,200,000, and declaratory relief.

On April 8, 2009, SCM, Mr. Marx, Secure Keyboards, Secure Networks, each of the respective general partners of Secure Keyboards and Secure Networks, and Hirsch entered into the 2009 Settlement Agreement, pursuant to which the parties resolved the disputes that had arisen between them relating to the acquisition and the 1994 Settlement Agreement. In connection with the 2009 Settlement Agreement, on April 9, 2009 the plaintiffs dismissed the Action without prejudice and agreed to dismiss said Action with prejudice after the closing of the acquisition of Hirsch. The acquisition of Hirsch closed on April 30, 2009. On May 5, 2009, the plaintiffs dismissed the Action with prejudice . The 2009 Settlement Agreement also contains releases among the parties, and those releases became effective upon the closing of the acquisition.

10. ROYALTY AGREEMENT AND RELATED PARTY TRANSACTIONS

Effective November 1994, the Company entered into a Settlement Agreement with two limited partnerships, Secure Keyboards, Ltd. (Keyboards) and Secure Networks, Ltd. (Networks), which are related to the Company through certain common shareholders and limited partners, including the Company s President, who owns 14% of the Company, 30% of Keyboards, and 9% of Networks. Under the terms of a previous agreement, the Company purchased the exclusive rights to certain patents and technology from Keyboards and Networks.

Under the terms of the Settlement Agreement, the Company has agreed to pay a royalty of 4.25% to Keyboards for the period from December 1, 1994 to December 31, 2020 and 5.5% to Networks for the period from December 1, 1994 to December 31, 2011, based on an allocation of revenues recognized by the Company starting at 55% and 45% of the Company s revenues for Keyboards and Networks, respectively. The royalty is payable when cash is received for the revenue recognized. The overall allocation of revenues recognized, upon which the respective royalty is calculated, will increase by 2.08% annually for Keyboards and decrease by 2.08% annually for Networks through December 31, 2011. No royalties will be payable to Networks for revenues recognized after December 31, 2011. The final payment to Networks is due on January 30, 2012. From January 1, 2012 to December 31, 2020, the royalty to Keyboards will be based on 4.25% of all revenues recognized by the Company. The final royalty payment to Keyboards is due on January 30, 2021.

During the three months ended February 28, 2009 and February 29, 2008, the Company paid approximately $0.2 million and $0.2 million, respectively, in royalties to Keyboards and Networks combined. At February 28, 2009 and November 30, 2008, the Company had a royalty payable of approximately $0.3 million and $0.3 million, respectively, to Keyboards and Networks combined.

HIRSCH ELECTRONICS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) February 28, 2009

11. SUBSEQUENT EVENTS

Acquisition

On December 10, 2008, the Company entered into an Agreement and Plan of Merger with SCM Microsystems, Inc. For each of the Hirsch shares outstanding, at the effective time of the Merger Hirsch stockholders will receive $3.00 cash, two shares of SCM common stock, and a warrant to purchase one share of SCM common stock at an exercise of $3.00. At the effective time, the Merger Agreement also provides that outstanding warrants to purchase shares of Hirsch common stock will be converted into warrants to acquire shares of SCM s Common Stock, and outstanding options to purchase shares of Hirsch common stock will be cancelled. The acquisition closed on April 30, 2009.

Royalty Agreement

Secure Keyboards, Secure Networks and Hirsch amended and restated the 1994 Settlement Agreement to replace the royalty-based payment arrangement under the 1994 Settlement Agreement with a new, definitive installment payment schedule. Hirsch s initial aggregate annual payment to Secure Keyboards and Secure Networks under the Amended and Restated 1994 Settlement Agreement for the period from January 1, 2009 through December 31, 2009 is $986,000, with subsequent annual payments subject to increase based on the percentage increase in the Consumer Price Index during the prior calendar year. Under the 1994 Settlement Agreement, royalties were previously based on a percentage of Hirsch revenues. Hirsch s payment obligations under the Amended and Restated 1994 Settlement Agreement will continue through the calendar year period ending December 31, 2020, unless Hirsch elects at any time on or after January 1, 2012 to earlier satisfy its obligations by making a lumpsum payment to Secure Keyboards. The amount of the lumpsum payment will be based on an assumed growth rate of the remaining annual payments of 4%, in lieu of the percentage increase in the Consumer Price Index, and a discount rate of 9%. SCM is not a party to the Amended and Restated 1994 Settlement Agreement. SCM has, however, provided Secure Keyboards and Secure Networks with a limited guarantee of Hirsch s payment obligations under such Amended and Restated 1994 Settlement Agreement. The Amended and Restated 1994 Settlement Agreement became effective and binding upon execution, provided that Sections 2 and 3 thereof became effective only upon the closing of the acquisition. The Guarantee also became effective upon the closing of acquisition of Hirsch.

BLUEHILL ID AG

INDEX TO FINANCIAL STATEMENTS

	Page
Unaudited Financial Statements:	
Bluehill ID AG Consolidated Balance Sheet as of December 31, 2008	F-86
Bluehill ID AG Consolidated Income Statement for the year ended December 31, 2008	F-87
Bluehill ID AG Consolidated Statement of Changes in Equity for the year ended December 31, 2008	F-88
Bluehill ID AG Consolidated Cash Flow Statement for the year ended for the year ended December 31, 2008	F-89
Notes to Consolidated Financial Statements	F-90
Multicard AG Interim Balance Sheet as of June 30, 2008	F-122
Multicard AG Profit and Loss Account as of June 30, 2008	F-123
Multicard GmbH, VS-Schwenningen Interim Balance Sheet as of June 30, 2008	F-124
TagStar Systems GmbH Interim Balance Sheet as of June 30, 2008	F-125
Tagstar Systems GmbH Profit and Loss Account as of June 30, 2008	F-126
Multicard GmbH, VS-Schwenningen Income Statement from January 1, 2008 to June 30, 2008	F-127
Multicard AG, Wallisellen, Switzerland Balance Sheets as of December 31, 2008 and December 31, 2007	F-128
Multicard AG, Wallisellen, Switzerland Income Statement 2008 and 2007	F-129
Additional Note to the Multicard AG, Wallisellen, Switzerland Financial Statements	F-132
Multicard GmbH, VS-Schwenningen Balance Sheet as of December 31, 2008	F-133
Multicard GmbH, VS-Schwenningen Income Statement from January 1, 2008 to December 31, 2008	F-134
Additional Note to the Multicard GmbH, Villingen-Schwenningen, Germany Financial Statements	F-135
Tagstar Systems GmbH Balance Sheet as of December 31, 2008	F-136
Tagstar Systems GmbH Profit and Loss Account from January 1, 2008 to December 31, 2008	F-137
Additional Note to the Tagstar GmbH, Sauerlach, Germany Financial Statements	F-139
Bluehill ID AG Interim Consolidated Statement of Financial Position as of June 30, 2009	F-140
Bluehill ID AG Interim Consolidated Statement of Comprehensive Income for the Six Months ended June 30, 2009	F-141
Bluehill ID AG Interim Consolidated Statement of Changes in Equity for the Six Months ended June 30, 2009	F-142
Bluehill ID AG Interim Consolidated Cash Flow Statement for the Six Months ended June 30, 2009	F-143
Bluehill ID AG Interim Consolidated Income Statement for the Six Months ended June 30, 2009	F-144
Notes to Consolidated Interim Financial Statements	F-145

BLUEHILL ID AG

CONSOLIDATED BALANCE SHEET
As of December 31, 2008

	Notes	2008 EUR (Unaudited)	2007 EUR
ASSETS			
Non-current assets			
Property, plant and equipment	10	1,577,136	--
Intangible assets	11	7,083,142	
Other non-current financial assets	12	3,405,472	1,208,200
Deferred tax assets	8	98,061	
		12,163,810	1,208,200
Current assets			
Inventories	14	1,481,463	
Trade and other receivables	15	2,829,321	41,175
Cash and short-term deposits	12, 16	7,725,298	6,433,239
Accrued assets	19	71,038	
		12,107,120	6,474,414
Total assets		24,270,931	7,682,614
EQUITY AND LIABILITIES			
Equity attributable to equity holders of the parent			
Share capital	17	16,418,986	6,362,755
Share premium	17	1,521,645	272,393
Currency translation reserve	17	(111,353)	
Retained earnings	17	(182,758)	(653,322)
		17,646,520	5,981,826
Equity attributable to minority interest			
Minority interest		(10,239)	
		(10,239)	
Total equity		17,636,281	5,981,826
Non-current liabilities			
Obligations under finance lease contracts	12	1,112,923	
Deferred tax liability	8	224,084	
		1,337,007	

Current liabilities			
Trade and other payables	12, 20	2,234,848	
Interest-bearing loans and borrowings	12	699,172	282,951
Other current financial liabilities	12	1,376,150	1,355,035
Deferred revenues	19	658,405	62,803
Provisions	18	263,295	
Income tax liability		65,773	
		5,297,642	1,700,788
Total liabilities		6,634,650	1,700,788
Total equity and liabilities		24,270,931	7,682,614

BLUEHILL ID AG

CONSOLIDATED INCOME STATEMENT
For the Year Ended December 31, 2008

	Notes	January 1 to December 31, 2008 EUR (Unaudited)	March 9 to December 31, 2007 EUR
Operations			
Sale of goods		5,884,850	
Other revenues		41,691	
Revenue		5,926,541	
Cost of sales		(3,326,011)	
Gross profit		2,600,530	
Other income	7	741,813	
Administrative expenses		(2,915,663)	(647,735)
Depreciation and amortization	7.3, 10, 11	(181,176)	
Salaries, wages and social expenses		(1,122,566)	
Other operating expenses		(30,932)	(51,464)
Other expenses			(12,975)
Operating profit		(907,994)	(712,174)
Finance costs	7.1	(2,137,607)	(54,546)
Finance income	7.2	3,512,467	113,398
Profit before tax (EBT)		466,866	(653,322)
Income tax expense	8	3,698	
Profit (+) / Loss (–) for the year		470,564	(653,322)
Earnings per share	9		
Basic earnings per share (undiluted)		0.026	(0.21)
Diluted earnings per share (diluted)		0.025	(0.21)
Weighted average number of shares outstanding during the period (undiluted)		18,107,589	3,068,289
Weighted average number of shares outstanding during the period (diluted)		19,065,105	3,068,289

BLUEHILL ID AG

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
For the Year Ended December 31, 2008

	Share Capital EUR	Share Premium EUR	Currency Translation Reserve EUR	Retained Earnings EUR (Unaudited)	Equity Attributable to Shareholders of Bluehill ID AG EUR	Minority Interests EUR	Total equity EUR
Inception March 9, 2007	61,600				61,600		61,600
Net profit of the period				(653,322)	(653,322)		(653,322)
Total income for period				(653,322)	(653,322)		(653,322)
Issue of new shares	6,301,155				6,301,155		6,301,155
Share-based payment		272,393			272,393		272,393
Balance at December 31, 2007	6,362,755	272,393		(653,322)	5,981,826		5,981,826
Currency translation adjustments			(111,353)		(111,353)		(111,353)
Net profit of the period				470,564	470,564		470,564
Total income (+) / loss (-) for period			(111,353)	470,564	359,211		359,211
Issue of new shares	10,056,231	1,281,458			11,337,689		11,337,689
Transaction costs		(517,002)			(517,002)		(517,002)
Tax effect on transaction costs		33,806			33,806		33,806
Share-based payment		450,990			450,990		450,990
Minority interest arising on business combination (Note 5)						(10,239)	(10,239)
Balance at December 31, 2008	16,418,986	1,521,645	(111,353)	(182,758)	17,646,520	(10,239)	17,636,281

BLUEHILL ID AG

CONSOLIDATED CASH FLOW STATEMENT
For the Year Ended December 31, 2008

	Notes	January 1 to December 31, 2008 EUR (Unaudited)	March 9 to December 31, 2007 EUR
Operating activities			
Profit (+) / Loss (−) after tax		470,564	(653,322)
Adjustment to reconcile profit after tax to net cash flows from operating activities:			
Non-cash			
Excess of acquirer s interest in the fair value of net assets over costs	7	(699,679)	
Increase (−) / Decrease (+) in financial instruments	12	(850,450)	
Depreciation (−) / Amortization (+) in tangible and intangible assets	7.3, 10, 11	181,176	
Interest income on loans and receivables	7.2	(205,785)	
Interest on debts and borrowings	7.1	139,919	
Increase (−) / Decrease (+) in deferred tax assets and liabilities	8	(10,583)	
Share-based payments expense (+)	17	450,990	272,393
Increase (−) / Decrease (+) in other assets		(1,380,073)	451,413
Increase (+) / Decrease (−) in other liabilities		1,569,669	
Net cash flows from operating activities		(334,251)	70,484
Investing activities			
Purchase (−) of intangible assets	11	(29,063)	
Sales (+) of intangible assets	11	113,784	
Purchase (−) of tangible assets	10	(82,459)	
Purchase of financial instruments(1)		(8,231,232)	
Proceeds from sale of financial instruments(2)		7,448,474	
Interest received		162,335	
Increase in third party loans		(1,986,621)	
Repayments of third party loans		1,208,200	
Acquisition of subsidiaries, net of cash acquired	5	(1,376,402)	
Net cash flow used in investing activities		(2,772,984)	
Financing activities			
Proceeds from issuing new shares	17	4,939,191	6,362,755
Capital raising fee to management company, commissions and tax	17	(517,002)	

Interest paid		(34,593)	
Net cash flow provided by financing activities		4,387,596	6,362,755
Net increase in cash and cash equivalents		1,280,361	6,433,239
Net foreign exchange difference	17	11,697	
Cash and cash equivalents at January 1	16	6,433,239	
Cash and cash equivalents at December 31	16	7,725,297	6,433,239

(1) The purchases of financial instruments includes cash, which was paid for equity instruments that are not subsidiaries.

(2) Proceeds from sale of financial instruments include cash, which results from sale of equity instruments that are not subsidiaries.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Corporate information

Bluehill ID AG is a limited company, incorporated and domiciled in Switzerland whose shares are publicly traded at the Frankfurt Stock exchange. The registered office is located at Dufourstr. 121, St. Gallen, Switzerland. The previous financial year 2007 contains the period from March 9, 2007 to December 31, 2007.

Bluehill ID companies design, manufacture and sell Radio Frequency Identification (RFID) products and components and other electronic components, and supply cards such as loyalty cards. Such products and components include RFID inlays sold to converters for use in ticketing and label manufacture, RFID and NFC readers sold to customers that have applications requiring the reading of RFID cards and documents, and the supply of customer loyalty cards. Products such as RFID and NFC readers incorporate software and firmware, developed by Bluehill ID companies, and such software and firmware form an integral part of the reader.

Bluehill ID is focused on building the world s leading group in identification (ID) technology. The company is dedicated to growing the overall ID market and to accelerating the acceptance of innovative technologies across multiple market sectors.

2.1 Basis of preparation

The consolidated financial statements have been prepared on a historical cost basis, except for financial instruments at fair value through profit or loss, which have been measured at fair value. The consolidated financial statements are presented in euros and all values are rounded except when otherwise indicated.

Statement of compliance

The consolidated financial statements of Bluehill ID have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

Basis of consolidation

The consolidated financial statements comprise the financial statements of Bluehill ID AG and its subsidiaries as at December 31, 2008. Subsidiaries are fully consolidated from the date of acquisition, being the date on which Bluehill ID obtains control, and continue to be consolidated until the date that such control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies.

All intra-group balances, income and expenses and unrealized gains and losses resulting from intra-group transactions are eliminated in full.

2.2 Changes in accounting policy and disclosures

The accounting policies adopted are consistent with those of the previous financial year except as follows:

Bluehill ID has adopted the following new and amended IFRS and IFRIC interpretations as of January 1, 2008. These new standards and interpretations did not affect the Bluehill ID s financial statements.

IFRIC 11 *IFRS 2 Group and Treasury Share Transactions*

IFRIC 12 *Service Concession Arrangements*

IFRIC 14 *IAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*

IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures Reclassification of Financial Assets Amendments*

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2.3 Summary of significant accounting policies

Business combinations and goodwill

Business combinations are accounted for using the purchase method. The cost of an acquisition is measured at fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at fair values at the date of acquisition, irrespective of the extent of any minority interest.

Goodwill is initially measured at cost being the excess of the cost of the business combination over Bluehill ID s share in the net fair value of the acquiree s identifiable assets, liabilities and contingent liabilities. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognized directly in the income statement.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of Bluehill ID s cash generating units that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Foreign currency translation

Bluehill ID s consolidated financial statements are presented in euros, which is the group s functional currency. That is the currency of the primary economic environment in which Bluehill ID AG operates. Each entity in the group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. Transactions in foreign currencies are initially recorded at the functional currency rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency spot rate of exchange ruling at the balance sheet date. All differences are taken to the income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value is determined.

The assets and liabilities of foreign operations are translated into euros at the rate of exchange prevailing at the balance sheet date and their income statements in general are translated at exchange rates prevailing at the date of the transactions. If the exchange rates for the translation of the income statement are not directly attributable to the transaction, Bluehill ID has used the average of the exchange rates of the period ending December 31, 2008. The exchange differences arising on the translation are taken directly to a separate component of equity.

Revenue recognition

Bluehill ID s revenues arise from products that are manufactured, packaged, delivered and invoiced against specific customer orders. Bought -in products are similarly packaged, delivered and invoiced against specific customer orders. The risks and rewards are transferred to the customer at the time of delivery and invoicing and revenue is recognized at that time. Bluehill ID companies had no long term contracts in 2008 that required percentage completion revenue recognition. Revenue is recognized to the extent that it is probable that the economic benefits will flow to Bluehill ID and the revenue can be reliably measured. Revenue is measured at the

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

fair value of the consideration received, excluding discounts, rebates, and sales taxes or duty. The following specific recognition criteria must also be met before revenue is recognized:

Sale of goods

Revenue from the sale of goods is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer, usually on delivery of the goods.

Interest income

Revenue is recognized as interest accrues (using the effective interest method). Interest income is included in finance revenue in the income statement.

Taxes

Current income tax

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

Current income tax relating to items recognized directly in equity is recognized in equity and not in the income statement.

Deferred income tax

Deferred income tax is provided using the liability method on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

> where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
>
> in respect of taxable temporary differences associated with investments in subsidiaries, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognized for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry forward of unused tax credits and unused tax losses can be utilized except:

where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and

in respect of deductible temporary differences associated with investments in subsidiaries, deferred income tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilized.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each balance sheet date and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date. Deferred income tax relating to items recognized directly in equity is recognized in equity and not in the income statement. Deferred income tax assets and deferred income tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

Share-based payment transactions

The share-based payments of Bluehill ID AG to Bluehill Capital Management AG are compensations with equity instruments. In return, the reporting company receives consulting services for its different operational fields. This includes preparing acquisitions and sales of investments and securities, the structured search for target companies suited for an investment and the examination of a company s investment suitability. Furthermore, services concerning the preparation and realization of negotiations with the target companies (Bluehill Capital Management AG), the administration of share ownership, the supervision of the portfolio businesses and general administrative tasks are provided. A further fundamental element is the organization of capital increases of Bluehill ID AG.

2,671,230 call options for 2,671,230 shares of Bluehill ID AG are currently issued to service providers as compensation. The strike price was 1 CHF per option. The period of exercising is five years. An early exercise of the option is possible anytime (American Options). To attend its option duties (not only for the described options), Bluehill ID AG performed a conditional capital increase. The contract party did not use its options by the closing date.

Because the fair value of the received services can not be reliably determined, the fair value of the granted equity instrument is used as a reference. The options are not directly tied to the length of service so the received services are entered at full value with an according change in equity. The fair value of the granted stock options at the time of provision is determined by using a binominal model according to Cox-Ross-Rubinstein.

Financial assets

Initial recognition

Financial assets within the scope of International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* (IAS 39) are classified as financial assets at fair value through profit or loss and loans and receivables. Bluehill ID determines the classification of its financial assets at initial recognition. Financial assets are recognized initially at fair value plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs.

Purchases or sales of financial assets that require delivery of assets within a time frame established by regulation or convention in the marketplace (regular way purchases) are recognized on the trade date, i.e., the date that Bluehill ID commits to purchase or sell the asset. Bluehill ID s financial assets include cash and short-term deposits, trade and other receivables, loan and other receivables, quoted and unquoted financial instruments.

Subsequent measurement

The subsequent measurement of financial assets depends on their classification as follows:

Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss includes financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss. Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Financial assets at fair value through profit and loss are carried in the balance sheet at fair value with gains or losses recognized in the income statement.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such financial assets are carried at amortized cost using the effective interest rate method. Gains and losses are recognized in the consolidated income statement when the loans and receivables are derecognized or impaired, as well as through the amortization process.

Financial liabilities

Initial recognition

Financial liabilities within the scope of IAS 39 are classified as loans and borrowings. Financial liabilities are recognized initially at fair value and in the case of loans and borrowings, directly attributable transaction costs. Bluehill ID s financial liabilities include trade and other payables, bank overdraft and loans and borrowings.

Subsequent measurement

The measurement of financial liabilities depends on their classification as follows:

Loans and borrowings

After initial recognition, interest bearing loans and borrowings are subsequently measured at amortized cost using the effective interest rate method. Gains and losses are recognized in the income statement when the liabilities are derecognized as well as through the amortization process.

Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount reported in the consolidated balance sheet if, and only if, there is a currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the assets and settle the liabilities simultaneously.

Fair value of financial instruments

The fair value of financial instruments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the balance sheet date. For financial instruments where there is no active market, fair value is determined using valuation techniques. Such techniques may include using recent arm s length market transactions; reference to the current fair value of another instrument that is substantially the same; discounted cash flow analysis or other valuation models.

Amortized cost of financial instruments

Amortized cost is computed using the effective interest method less any allowance for impairment and principal repayment or reduction. The calculation takes into account any premium or discount on acquisition and includes transaction costs and fees that are an integral part of the effective interest rate.

Impairment of financial assets

Bluehill ID assesses at each balance sheet date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred loss event) and that loss event has an impact on the estimated future cash flows of the financial asset or Bluehill ID of financial assets that can be reliably estimated. Evidence of impairment may include indications that the debtors or a group of debtors is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganisation and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Due from loans and advances to customers

For amounts due from loans and receivables carried at amortized cost, Bluehill ID first assesses individually whether objective evidence of impairment exists individually for financial assets that are individually significant, or collectively for financial assets that are not individually significant. Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realized or has been transferred to Bluehill ID. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a future write-off is later recovered, the recovery is recognized in the income statement.

Derecognition of financial instruments

Financial assets

A financial asset is derecognized when:

the rights to receive cash flows from the asset have expired; or

Bluehill ID has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a pass-through arrangement; and either

Bluehill ID has transferred substantially all the risks and rewards of the asset, or

Bluehill ID has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

When Bluehill ID has transferred its rights to receive cash flows from an asset or has entered into a passthrough arrangement, and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, a new asset is recognized to the extent of Bluehill ID s continuing involvement in the asset.

Financial liabilities

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expires. When an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognized in the income statement.

Plant and equipment

Plant and equipment is stated at cost, net of accumulated depreciation and/or accumulated impairment losses, if any. Such cost includes the cost of replacing part of the plant and equipment and borrowing costs for long-term construction projects if the recognition criteria are met. Likewise, when a major inspection is performed, its cost is recognized in the carrying amount of the plant and equipment as a replacement if the recognition criteria are satisfied. All other repair and maintenance costs are recognized in the income statement as incurred. The present value of the expected cost for the decommissioning of the asset after its use is included in the cost of the respective asset if the recognition criteria for a provision are met.

Depreciation is calculated on a straight-line basis over the useful life of the asset as follows:

Plant and equipment five to seven years

Other equipment and tools three to six years

An item of property, plant and equipment is derecognized upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

difference between the net disposal proceeds and the carrying amount of the asset) is included in the income statement in the year the asset is derecognized.

The assets residual values, useful lives and methods of depreciation are reviewed at each financial year end, and adjusted prospectively if appropriate.

Leases

The determination of whether an arrangement is, or contains a lease is based on the substance of the arrangement at inception date: whether fulfilment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset.

Group as a lessee

Finance leases, which transfer to Bluehill ID substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the commencement of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are recognized in the income statement. Leased assets are depreciated over the useful life of the asset. However, if there is no reasonable certainty that Bluehill ID will obtain ownership by the end of the lease term, the asset is depreciated over the shorter of the estimated useful life of the asset and the lease term.

Operating lease payments are recognized as an expense in the income statement on a straight line basis over the lease term.

Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and any accumulated impairment losses. Internally generated intangible assets, excluding capitalized development costs, are not capitalized and expenditure is reflected in the income statement in the year in which the expenditure is incurred.

The useful lives of intangible assets are assessed as either finite or indefinite. Intangible assets with finite lives are amortized over the useful economic life and assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortization period and the amortization method for an intangible asset with a finite useful life is reviewed at least at each financial year end. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset is accounted for by changing the amortization period or method, as appropriate, and are treated as changes in accounting estimates. The amortization expense on intangible assets with finite lives is recognized in the income statement in the expense category consistent with the function of the intangible asset.

Intangible assets with indefinite useful lives are not amortized, but are tested for impairment annually. The assessment of indefinite life is reviewed annually to determine whether the indefinite life continues to be supportable. If not, the change in useful life from indefinite to finite is made on a prospective basis.

Gains or losses arising from derecognition of an intangible asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset and are recognized in the income statement when the asset is derecognized.

Research and development costs

Research costs are expensed as incurred. Development expenditure on an individual project is recognized as an intangible asset when Bluehill ID can demonstrate:

the technical feasibility of completing the intangible asset so that it will be available for use or sale;

its intention to complete and its ability to use or sell the asset;

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

how the asset will generate future economic benefits;

the availability of resources to complete the asset; and

the ability to measure reliably the expenditure during development.

Following initial recognition of the development expenditure as an asset, the cost model is applied requiring the asset to be carried at cost less any accumulated amortization and accumulated impairment losses. Amortization of the asset begins when development is complete and the asset is available for use. It is amortized over the period of expected future benefit. During the period of development, the asset is tested for impairment annually.

The finite useful lives are up to 10 years.

Patents

The patents have been granted for a period of 10 years by the relevant government agency with the option of renewal at the end of this period.

Customer lists

Customer lists occurred from the acquisition of subsidiaries. The evaluation of such customer lists is an approximate estimation. These customer lists are not based on consisting customer contracts. The group estimates a useful live of five to ten years.

A summary of the policies applied to Bluehill ID s intangible assets is as follows:

	Patents	**Development Costs**	**Customer lists**
Useful lives	Finite	Finite	Finite
Amortization method used	Amortized on a straight line basis over the period of the patent	Amortized over the period of expected future sales from the related project on a straight line basis	Amortized over the period of expected future sales from the customer list on a straight line basis
Internally generated or acquired	Acquired	Internally generated	Acquired

Inventories

Inventories are valued at the lower of cost and net realizable value. Costs incurred in bringing each product to its present location and condition are accounted for as follows:

Raw materials	purchase cost on a first in, first out basis.
Finished goods and work in progress	cost of direct materials and labour and a proportion of manufacturing overheads based on normal operating capacity but excluding borrowing costs.

Net realizable value is the estimated selling price in the ordinary course of business, less estimated costs of completion and the estimated costs necessary to make the sale.

Impairment of non-financial assets

Bluehill ID assesses at each reporting date whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, Bluehill ID estimates the asset s recoverable amount. An asset s recoverable amount is the higher of an asset s or cash-generating unit s (CGU) fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Impairment losses of continuing operations are recognized in the income statement in those expense categories consistent with the function of the impaired asset.

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, Bluehill ID estimates the asset s or cash-generating unit s recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the assumptions used to determine the asset s recoverable amount since the last impairment loss was recognized. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the income statement unless the asset is carried at revalued amount, in which case the reversal is treated as a revaluation increase.

The following criteria are also applied in assessing impairment of specific assets:

Goodwill

Goodwill is tested for impairment annually after first recognition and when circumstances indicate that the carrying value may be impaired. Impairment is determined for goodwill by assessing the recoverable amount of each cash-generating unit to which the goodwill relates. Where the recoverable amount of the cash-generating unit is less than their carrying amount an impairment loss is recognized. Impairment losses relating to goodwill cannot be reversed in future periods.

Cash and short-term deposits

Cash and short-term deposits in the balance sheet comprise cash at banks and on hand and short-term deposits with an original maturity of three months or less. For the purpose of the consolidated cash flow statement, cash and cash equivalents consist of cash and short-term deposits as defined above, net of outstanding bank overdrafts.

Provisions

General

Provisions are recognized when Bluehill ID has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where Bluehill ID expects some or all of a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the income statement net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as a finance cost.

3. Significant accounting judgements, estimates and assumptions

The preparation of Bluehill ID s consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the disclosure of contingent liabilities, at the reporting date. However, uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of the asset or liability affected in future periods.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Judgments

In the process of applying Bluehill ID s accounting policies, management has made the following judgments which have the most significant effect on the amounts recognized in the consolidated financial statements:

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

Impairment of Non-financial Assets

Bluehill ID s impairment test for goodwill and intangible assets with indefinite useful lives is based on value in use calculations that use a discounted cash flow model. The cash flows are derived from the budget and forecasts for the next five years and do not include restructuring activities that Bluehill ID is not yet committed to or significant future investments that will enhance the asset base of the cash generating unit being tested. The recoverable amount is most sensitive to the discount rate used for the discounted cash flow model as well as the expected future cash-inflows and the growth rate used for extrapolation purposes.

Share-based Payments

Bluehill ID measures the cost of equity-settled transactions with Bluehill Capital Management AG by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value for share-based payments requires determining the most appropriate valuation model for a grant of equity instruments, which is dependent on the terms and conditions of the grant. This also requires determining the most appropriate inputs to the valuation model including the expected life of the option, volatility and dividend yield and making assumptions about them.

Deferred Tax Assets

Deferred tax assets are recognized for all unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits together with future tax planning strategies. Bluehill ID has tax loss carryforwards amounting to 684,303 (2007: 0). These losses relate to subsidiaries that have a history of losses, do not expire and may not be used to offset taxable income elsewhere in Bluehill ID. The subsidiary has no temporary taxable differences which could partly support the recognition of deferred tax assets. Also, there are no tax planning opportunities available that would further provide a basis for recognition.

Fair Value of Financial Instruments

Where the fair value of financial assets and financial liabilities recorded in the balance sheet cannot be derived from active markets, they are determined using valuation techniques including the discounted cash flows model. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. The judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

Development Costs

Development costs are capitalized in accordance with the accounting policy in Note 2.3. Initial capitalization of costs is based on management s judgment that technological and economical feasibility is confirmed, usually when a product development project has reached a defined milestone according to an established project management model. In determining the amounts to be capitalized management makes assumptions regarding

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the expected future cash generation of the project, discount rates to be applied and the expected period of benefits. At December 31, 2008, the carrying amount of capitalized development costs was 131,037 (2007: 0).

This amount includes significant investments in the development of innovative software and hardware products for RFID. Because of the innovative nature of the products, there is some uncertainty as to whether the development will be successfully completed.

4. Standards, Amendments and Interpretations that are not yet Effective in 2008 and have not been Early Adopted by Bluehill ID

Standard / Interpretation	Title	Effective Date
IAS 1	Presentation of Financial Statements Revised	January 1, 2009
IFRS 1 / IAS 27	Amendments Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate Amendments	January 1, 2009
IFRS 2	Share-based Payment Vesting Conditions and Cancellations Amendment	January 1, 2009
IFRS 3	Business Combinations Revised	July 1, 2009
IFRS 8	Operating Segments	January 1, 2009
IAS 23	Borrowing Costs- Revised	January 1, 2009
IAS 27	Consolidated and Separate Financial Statements Amendment	July 1, 2009
IAS 32 and IAS 1	Amendments Puttable Financial Instruments and Obligations Arising on Liquidation	January 1, 2009
IAS 39	Financial Instruments: Recognition and Measurement Eligible hedged items Amendment	July 1, 2009
IFRS 7	Improving Disclosures about Financial Instruments (Amendments to IFRS 7)	January 1, 2009
Annual Improvements	Omnibus Changes to many standards	Mostly January 1, 2009 (amendment to IFRS 5 is effective July 1, 2009)
IFRIC 13	Customer Loyalty Programs	July 1, 2008
IFRIC 15	Agreements for the Construction of Real Estate	January 1, 2009
IFRIC 16	Hedges of a Net Investment in a Foreign Operation	October 1, 2008
IFRIC 17	Distributions of Non-cash Assets to Owners	July 1, 2009
IFRIC 18	Transfers of Assets from Customers	January 1, 2009

The following standards and interpretations will be relevant for Bluehill ID:

IFRS 8: Operating Segments

This standard was published in November 2006, and replaces IAS 14 Segment Reporting. IFRS 8 requires entities to define operating segments and segment performance in the financial statements based on information

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

used by the chief operating decision-maker. This new standard has could lead to the identification of different operating segments in subsequent periods.

IAS 1: Presentation of Financial Statements Revised

This amendment requires information in financial statements to be aggregated on the basis of shared characteristics and to introduce a statement of comprehensive income. This will enable readers to analyze changes in a company s equity resulting from transactions with owners in their capacity as owners (such as dividends and share repurchases) separately from non-owner changes (such as transactions with third parties). Bluehill ID has not undergone a detailed analysis and therefore no final assessment of the impact can presently be made.

Improvements to IFRS

In May 2008 the board issued its first omnibus of amendments to its standards primarily with the goal to remove inconsistencies and clarifying wording. Bluehill ID has not undergone a detailed analysis and therefore no final assessment of the impact can presently be made.

5. Business combinations and acquisition of minority interests Acquisitions in 2008

Acquisition of ACiG AG, Arygon AG, Tagstar GmbH, Multicard AG, ACiG Technology Ltda., Scolis Ltd., Bluehill Microtech GmbH , 4446691 Canada Inc.

On December 31, 2008, Bluehill ID acquired 100% of the voting shares of ACiG AG, an unlisted company based in Germany specialising in the distribution and supply chain management of RFID products and components. On December 31, 2008, Bluehill ID acquired 91% of the voting shares of Arygon AG, an unlisted company based in Germany specialising in the development, production and sale of RFID and NFC readers and components. On June 30, 2008, Bluehill ID acquired 100% of the shares of Tagstar GmbH, an unlisted company based in Germany specialising in the design, development and production of smart inlays for RFID applications. On June 30, 2008, Bluehill ID acquired 100% of the voting shares of Multicard AG, an unlisted company based in Switzerland specialising in the supply of card management services and provision of turnkey solutions for secure identification programs. On September 30, 2008, Bluehill ID acquired 100% of the voting shares of ACiG Technology Ltda., an unlisted company based in Brazil specialising in the distribution of electronic components. On December 31, 2008, Bluehill ID acquired 100% of the voting shares of Scolis Ltd., an unlisted company based in India and Singapore specialising in the development of RFID and NFC readers and software. On June 30, 2008, Bluehill ID acquired 100% of the voting shares of Bluehill Microtech GmbH, an unlisted company based in Germany. On December 31, 2008, Bluehill ID acquired 100% of the voting shares of 4446691 Canada Inc., an unlisted company based in Canada.

Cost **(Unaudited)**	
Cash	2,009,589
Fair value of shares issued	4,789,955
Costs associated with the acquisition	282,524

Total	7,082,068
Cash outflow on acquisition:	
Net cash acquired with the subsidiary	767,812
Cash paid	2,144,214
Net cash outflow	(1,376,402)

The number of equity instruments issued or issuable for acquisition purposes amounts 6,766,797.

The price determination for acquiring subsidiaries was done by first determining a cash price for the acquisition, and second, determining how much of the payable amount would be covered by cash and how much

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

by Bluehill ID shares. The value that Bluehill ID and the selling party have negotiated for Bluehill ID shares is the value that is displayed in the table above, which therefore is considered as the fair value.

Although Bluehill ID is a listed company, the value Bluehill ID and the selling parties have agreed on for Bluehill ID shares is not always the market value. Therefore, the market value is not the fair value for Bluehill ID shares for the respective acquisitions. The reason is thinness of the market: Large trades have a significant effect on the market price of Bluehill ID shares. The market price becomes unreliable for such large share deals and can therefore not be used to measure the fair value of Bluehill ID shares. This is in accordance with IFRS 3.27. The fair value attributed amounts 4,789,955. The difference between the fair value attributed to, and the published price of, the equity instruments is 3,972,901.

The fair value of the identifiable assets and liabilities of all acquired companies as at the date of acquisition were:

(Unaudited)	**Fair Value Recognized on Acquisition**
Intangible assets	247,075
Customer list	859,055
Property, plants and equipment	1,665,488
Financial instruments	685,066
Deferred tax assets	16,849
Inventories	1,499,383
Trade receivables	1,987,818
Other assets	97,798
Cash and cash equivalents	767,812
Total assets	7,826,344
Provisions	531,761
Trade payables and liabilities	5,372,667
Deferred tax liabilities	222,506
Total liabilities	6,126,934
Net assets	1,699,410
Minority interests of negative equity	10,239
Total net assets acquired	1,709,649
Goodwill arising on acquisition	6,072,098
Excess of acquirer s interest in the fair value of net assets	(699,679)
Total consideration	7,082,068

Goodwill is principally related to synergies and other intangible assets not qualifying for separate recognition. Such synergies result principally from production and sale of RFID components and collaborative research and development.

Bluehill ID s profit for the year of 470,564 includes profit from the acquired companies of 337,766. IFRS revenue and profit figures for the acquisitions prior to acquisition are not available and are therefore not reported.

Disclosures of the carrying amounts of each classes of the acquiree s assets and liabilities, determined in accordance with IFRS, immediately before the combination are impracticable. The acquired companies are unlisted small and medium-sized companies, which were not able to deliver information in accordance with IFRS.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The initial accounting of the goodwill for some acquisitions is provisional, due to changes in the fair value of net assets and the cost of the business combination. The provisional purchase price allocation is reflected in the fair values as reported in the table above.

Due to the outcome of some earn-outs not being finalised until 2010, it is possible that the goodwill has to be adjust in future. The probability of the earn-outs cannot be measured reliably but the management assumes that the earn-outs will not be effective.

The customer lists are intangible assets that are part of the acquisition. These intangibles have useful lives of five to ten years and will be tested for impairment annually. At the balance sheet date there was no evidence for an impairment. The valuation of the customer lists is provisional.

The reported minority interests arise from a minority shareholding in a subsidiary with a negative equity.

6. Segment information

Primary Segment Information

Based on risks and rates of return the Management considers that the primary reporting format is by business segment. The Management considers that there is only one business segment as the origin and type of risks of the different products are practically identical. Bluehill ID s business consists of very similar products for identification purposes only, which are globally available. Therefore the disclosures for the primary segment have already been given in these financial statements. The secondary reporting format is by geographical analysis based on the location of assets.

Secondary Segment Information

Bluehill ID is active in one geographical region: Germany-Switzerland. Therefore the disclosures for the secondary segment also have already been given in these financial statements. The adoption of the new standard IFRS 8 could lead to the identification of different operating segments.

7. Other income

	2008	2007
		(Unaudited)
Excess of acquirer s interest in the fair value of net assets, over cost	699,679	
Other income	42,134	
Total	741,813	

7.1 Finance costs

	2008	2007
	(Unaudited)	
Interest on debts and borrowings	139,919	54,546
Foreign currency translation	1,997,688	
Total interest expense	2,137,607	54,546

7.2 Finance income

	2008	2007
	(Unaudited)	
Interest income on loans and receivables	205,785	113,398
Foreign currency translation	2,456,232	
Net gains on financial assets at fair value through profit or loss	850,450	
Total finance income	3,512,467	113,398

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7.3 Depreciation and amortization

	2008	2007
	(Unaudited)	
Plant and Equipment	170,811	
Intangible assets	10,365	
Total	181,176	

8. Income tax

The major components of income tax expense for the years ended December 31, 2008 and 2007 are:

Consolidated income statement

	2008	2007
	(Unaudited)	
Current income tax:		
Current income tax charge	40,691	
Current and deferred income tax:		
Relating to origination and reversal of temporary differences	(44,389)	
Income tax expense reported in the income statement	(3,698)	

Consolidated statement of changes in equity

	2008	2007
	(Unaudited)	
Deferred income tax related to items charged or credited directly to equity during the year:		
Tax effect on transaction costs	33,806	
Increase of tax assets reported in equity	33,806	

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A reconciliation between tax expense and the product of accounting profit multiplied by Bluehill ID s domestic tax rate of 7.9% for the years ended December 31, 2008 and 2007 is as follows:

	2008	2007
	(Unaudited)	
Accounting profit before income tax	466,866	(653,322)
At Bluehill ID s statutory income tax rate of 7.9%	36,882	(124,131)
Not recognized deferred tax assets on loss carry forward	80,212	124,131
Non deductable expenses of share-based payments	35,628	
Effect of foreign exchange losses	(44,932)	
Effect of different tax rates in:	42,380	
Germany	41,842	
Switzerland	18,848	
United States	(6,263)	
Brazil	(12,047)	
Effect from expenses directly related to the issue of equity instruments	(33,857)	
Other non taxable income through profit or loss	(55,275)	
Utilisation of previously unrecognized tax losses	(55,467)	
Other	(9,269)	
Income tax expense reported in the consolidated income statement	(3,698)	

The options issued due to share-based payments with an amount of 450,990 (2007: 272,393) cause permanent differences (see Note 2 and 17). For that reason deferred taxes are not capitalized. All expenses not be deducted of (9,305) (2007: 0) consist of share-based payments.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred income tax

Deferred income tax at December 31 relates to the following:

	Consolidated Balance Sheet		Consolidated Income Statement	
	2008	2007	2008	2007
		(Unaudited)		
Deferred tax assets				
Leasing liabilities	270,644		61,518	
Impairment of financial assets	81,307		(81,307)	
Total deferred tax assets	351,951		(19,789)	
Deferred tax liabilities:				
Capitalization of leasing assets and intangible assets	(273,986)		(24,600)	
Capitalization of customer lists and other	(203,988)			
Total deferred tax liabilities	(477,974)		(24,600)	
Deferred income tax expense/(income)			(44,389)	
Deferred tax liabilities net	(126,023)			
Reflected as deferred tax assets	98,061			
Reflected as deferred tax liabilities	(224,084)			
Deferred tax liabilities net	(126,023)			

Deferred tax assets and liabilities are offset if, and only if, they can be used against one and the same tax authority.

Bluehill ID has tax losses in total of 684,303 which arose mainly in Switzerland 475,427 the United States 88,206, Brazil 74,531 and Germany 46,139, that are available in general for six to seven years for offset against future taxable profits of the companies in which the losses arose. Deferred tax assets have not been recognized in respect of these losses as they may not be used to offset taxable profits elsewhere in Bluehill ID and they have arisen in subsidiaries that have been loss-making for some time.

9. Earnings per share

Basic earnings per share amounts are calculated by dividing net profit for the year attributable to ordinary equity holders of the parent by the weighted average number of ordinary shares outstanding during the year.

Diluted earnings per share amounts are calculated by dividing the net profit attributable to ordinary equity holders of the parent by the weighted average number of ordinary shares outstanding during the year plus the weighted average number of ordinary shares that would be issued on conversion of all the dilutive potential ordinary shares into ordinary shares. The effect of dilution is caused by the issue of options to Bluehill Capital Management AG as mentioned in Note 2.3. The options are part of share-based payments for services provided by Bluehill Capital Management AG such as treasury including short term deposits and foreign currency management.

The following reflects the income and share data used in the basic and diluted earnings per share computations:

	2008	**2007**
	(Unaudited)	
Net profit/loss attributable to ordinary equity holders of the parent for basic earnings and adjusted for the effect of dilution	470,564	$ (653,322)

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	2008 (Unaudited)	2007
Weighted average number of ordinary shares for basic earnings per share	18,107,589	3,068,289
Effect of dilution:		
Share options	957,516	
Weighted average number of ordinary shares adjusted for the effect of dilution	19,065,105	3,068,289

10. Property, plant and equipment

	Plant and Equipment 2008 (Unaudited)	2007
At December 31		
Additions		
Increase due to acquisitions of subsidiaries	1,665,488	
Purchase of the year	82,459	
At December 31	1,747,947	
Depreciation and impairment:		
At December 31		
Depreciation charge for the year	170,811	
At December 31	170,811	
Net book value:		
At December 31	1,577,136	
At January 1		

The increase of plant and equipment due to acquisitions of subsidiaries includes leased assets of 1,070,172 (2007: 0). None of these assets acquired is pledged.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Intangible assets

	Development		Customer		
	Costs	Patents	Lists	Goodwill	Total
			(Unaudited)		
Cost:					
At inception March 9, 2007					
Purchase/sale of the year					
At December 31, 2007					
Acquisition of subsidiaries	101,974	145,101	859,055	6,072,098	7,178,228
Purchase of the year	29,063				29,063
Sale of the year		(113,784)			(113,784)
At December 31, 2008	131,037	31,317	859,055	6,072,098	7,093,507
Amortization and impairment:					
At December 31, 2007					
Amortization		10,365			10,365
Net book value:					
At December 31, 2008	131,037	20,952	859,055	6,072,098	7,083,142
At December 31, 2007					
At January 1, 2007					

Acquisition during the year

Patents include intangible assets acquired through business combinations. These patents have been granted for a minimum of 10 years by the relevant government agency.

The customer lists of 859,055 (2007: 0) are intangible assets that are part of the acquisition. These intangibles have in general a finite useful live of five to ten years. Furthermore it will be tested for impairment annually and whenever there is an indication that the intangible asset may be impaired (Note 2.3 and 5). At the balance sheet date there was no evidence for an impairment. Bluehill ID will start with the depreciation in 2009. The valuation of the customer lists is provisional.

Bluehill ID capitalized development costs, which have a finite useful life. Because the depreciation of development costs is not material in 2008 and because Bluehill ID cannot identify a reliable useful life Bluehill ID decided to start with the depreciation in 2009.

The Goodwill of 6,072,098 (2007: 0) is principally related to synergies and other intangible assets not qualifying for separate recognition. Such synergies result principally from production and sale of RFID components and collaborative research and development (Note 5).

12. Other financial assets and financial liabilities

Other financial assets

Bluehill ID distinguishes financial instruments in different classes, as follows:

Non-current loans and receivables

Financial assets designated as at fair value through profit or loss

Trade and other receivables

Non-current other financial liabilities

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Trade and other payables

Interest-bearing loans and borrowings

Other current financial liabilities

For evaluation purposes Bluehill ID uses the following categories of financial instruments:

Loans and receivables

Financial assets designated as at fair value through profit or loss

Other liabilities at amortized cost

	2008	2007
	(Unaudited)	
Loans and receivables	767,671	1,208,200
Including loan to related party	382,547	1,208,200
Financial assets designated as at fair value through profit or loss	2,637,801	
Total non-current other financial assets	3,405,472	1,208,200
Trade and other receivables	2,829,321	41,175
Total current financial assets	2,829,321	41,175
Total financial assets	6,234,793	1,249,375

The loan to related party include a loan to Mountain Partners AG (2007: 1,208,200) and a loan of 382,547 (2007: 0) to Bluehill Capital Management AG as mentioned in Note 21.

The financial assets designated as at fair value through profit or loss consists of shares of quoted companies that have been purchased during the year. Bluehill ID has designated these shares as financial instruments at fair value through profit or loss because the assets are managed by Bluehill ID s key management personnel using the fair value. The shares are evaluated on a fair value basis, in accordance with Bluehill ID s risk management. The valuation is based on quoted share price in active markets in accordance to Bluehill ID s investment manual.

Other financial liabilities

	2008	2007
	(Unaudited)	
Obligations under finance lease contracts	1,112,923	
Total non-current other financial liabilities	1,112,923	
Trade and other payables	1,235,964	
Other current financial liabilities	1,376,150	1,355,035
Interest-bearing loans and borrowings	699,172	282,951
Total current other financial liabilities	3,311,286	1,637,986
Total other liabilities at amortized cost	4,424,209	1,637,986

The non-current financial liabilities at amortized cost in 2008 of 1,112,923 (2007: 0) are liabilities caused by leasing contracts.

Current financial liabilities at amortized cost of 3,311,286 (2007: 1,637,986) consist of amounts owed to Mountain Partners AG of 699,172 (2007: 282,951) as mentioned in Note 21 and aggregated liabilities at amortized cost of the subsidiaries. Furthermore current other financial liabilities consist of trade and other payables 1,235,964 (2007: 0) and other current financial liabilities 1,376,150 (2007: 1,355,035).

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest-bearing loans and borrowings

	Effective Interest Rate	Maturity	2008 (Unaudited)	2007
Current:				
Other loans:				
Related parties	0%	On demand	699,172	282,951
Total			699,172	282,951
Non-current:				
Obligations under finance leases	6-21%	2009-2012	1,112,923	
Total			1,112,923	

Fair values

Set out below is a comparison by class of the carrying amounts and fair value of Bluehill ID s financial instruments that are carried in the financial statements.

	Carrying Amount		Fair Value	
	2008	2007	2008 (Unaudited)	2007
Financial assets:				
Cash and short-term deposits	7,725,298	6,433,239	7,725,298	6,433,239
Non-current loans and receivables	767,671	1,208,200	767,671	1,208,200
Financial assets designated as at fair value through profit or loss	2,637,801		2,637,801	
Trade and other receivables	2,829,321	41,175	2,829,321	41,175
Financial liabilities:				
Non-current other financial liabilities	1,112,923		1,112,923	
Trade and other payables	1,235,964		1,235,964	
Interest-bearing loans and borrowings	699,172	282,951	699,172	282,951
Other current financial liabilities	1,376,150	1,355,035	1,376,150	1,355,035

Net gain or loss on financial assets at fair value through profit or loss (Note 7.2):

	2008	**2007**
	(Unaudited)	
Gains on financial assets at fair value through profit or loss	850,450	
Net gain	850,450	

13. Impairment testing of goodwill

The initial allocation of the goodwill was not completed by the year-end. Accordingly, no impairment test was carried on in 2008. At the balance sheet date there is no evidence of impairment.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Inventories

	2008 (Unaudited)	2007
Raw materials (at cost)	373,194	
Work in progress (at cost)	165,531	
Finished goods (at cost or net realizable value)	861,528	
Prepayments	81,210	
Total inventories at the lower of cost and net realizable value	1,481,463	

The amount of write-down of inventories recognized as an expense is 0 (2007: 0).

15. Trade and other receivables (current)

	2008 (Unaudited)	2007
Trade receivables	1,800,874	
Other assets	971,079	902
Receivables from other related parties	57,368	40,273
Total	2,829,321	41,175

Trade receivables are non-interest bearing and are generally on 30-90 day terms. As of December 31, 2008, trade receivables at initial value of 160,992 (2007: 0) were impaired and fully provided for. See next chart for the movements in the provision for impairment of receivables.

	Individually Impaired	Collectively Impaired (Unaudited)	Total
At December 31, 2007			
Additions	160,992		160,992
At December 31, 2008	160,992		160,992

As of December 31, the ageing analysis of trade receivables is as follows:

	Total	Neither Past Due Nor Impaired	Past Due But Not Impaired <30 Days	30-60 Days	60-90 Days	90-120 Days	>120 Days
			(Unaudited)				
2008	2,829,321	2,829,321					
2007	41,175	41,175					

16. Cash and short-term deposits

	2008	2007
	(Unaudited)	
Cash at banks and on hand	7,725,298	6,433,239
Total	7,725,298	6,433,239

Cash at banks earn interest at floating rates based on daily bank deposit rates.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

17. Issued capital and reserves

Authorized shares

	2008	2007
	(Unaudited)	
Ordinary share of CHF 1 each	26,712,297	10,550,000
Total	26,712,297	10,550,000

During the year, the authorized share capital was increased by 10,056,231 by the creation of 16,162,297 ordinary shares of CHF 1 each.

***Ordinary shares issued and fully paid*[1]**

	Number of Share	
		(Unaudited)
At December 31, 2007	10,550,000	6,362,755
Capital Increase Date		
Issued on March 4, 2008	7,100,000	4,379,990
Issued on July 9, 2008	1,550,000	952,165
Issued on July 28, 2008	4,400,000	2,741,651
Issued on August 13, 2008	1,665,000	1,022,144
Issued on December 17, 2008	1,447,297	960,281
At December 31, 2008	26,712,297	16,418,986

Share Premium

	2008 (Unaudited)
At Inception March 9, 2007	
Currency translation adjustments	
Expenses recognized directly in equity	
Deferred taxes on expenses recognized directly in equity	

Issue of new shares	
Share-based payment	272,393
At December 31, 2007	272,393
Expenses recognized directly in equity	(517,002)
Deferred taxes on expenses recognized directly in equity	33,806
Issue of new shares	1,281,458
Issued on July 9, 2008	952,165
Issued on December 17, 2008	329,293
Share-based payment	450,990
At December 31, 2008	1,521,645

[1] 4.939.191 of the issued capital in 2008 have been paid cash.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Retained earnings and profit of the period

	2008	2007
	(Unaudited)	
At January 1	(653,322)	
Profit / loss of the period	470,564	(653,322)
At December 31	(182,758)	(653,322)

18. Provisions

	Maintenance Warranties		Other Provisions
		(Unaudited)	
At January 1, 2008			
Acquisition of subsidiaries	180,220		83,075
At December 31, 2008	180,220		83,075
Current 2008	180,220		83,075
Non-current 2008			
Total provisions		263,295	

Maintenance warranties

A provision is recognized for expected warranty claims on products sold during the last two years, based on past experience of the level of repairs and returns. It is expected that most of these costs will be incurred in the next financial year and all will have been incurred within two years of the balance sheet date. Assumptions used to calculate the provision for warranties were based on current sales levels and current information available about returns based on the two-year warranty period for all products sold.

19. Accruals

	Accrued Assets		Deferred Revenues	
	2008	2007	2008	2007
		(Unaudited)		

At January 1		62,803	
Accrued during the year	71,038	645,536	62,803
At December 31	71,038	708,339	62,803
Current	71,038	708,339	62,803
Total	71,038	708,339	62,803

The accrued liabilities of 708,339 (2007: 62,803) mainly consists of deferred revenues related with acquisitions within the Bluehill ID AG stand alone financial report.

20. Trade and other payables (current)

	2008 **(Unaudited)**	**2007**
Trade payables	1,152,556	
Received prepayments	83,408	
Other payables	998,884	
Total	2,234,848	

Table of Contents

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Terms and conditions of the above mentioned financial liabilities:

Trade payables are non-interest bearing and are normally settled on 60-day term.

Received prepayments are non-interest bearing and have an average term of six month.

Interest payable is normally settled quarterly throughout the financial year.

For terms and conditions relating to related parties, refer to next paragraph.

21. Related party disclosures

The financial statements include the financial statements of Bluehill ID AG and the subsidiaries listed in the following table:

Name	Country of Incorporation	% Equity Interest 2008	2007
		(Unaudited)	
Multicard AG	Switzerland/Germany	100	0
Tagstar GmbH	Germany	100	0
ACiG Technology Ltda.	Brazil/USA	100	0
AciG AG	Germany	100	0
Arygon AG	Germany	91	0
Scolis Ltd.	Singapore/ India	100	0
Bluehill Microtech GmbH	Germany	100	0
4446691 Canada Inc.	Canada	100	0

The following table provides the total amount of transactions that have been entered into with related parties for the relevant financial year (for information regarding outstanding balances at December 31, 2008 and 2007:

	Amounts Owed by Related Parties		Amounts Owed to Related Parties	
	2008	2007	2008	2007
			(Unaudited)	
Entity with significant influence over Bluehill ID:				
Mountain Partners AG			699,172	282,951

	Interest Received		Amounts Owed by Related Parties	
Loans from/to Related Party:				
Bluehill Capital Management AG	24,192		383,547	
Mountain Partners AG	9,736	39,940		1,208,200

	Share-Based Payments to Related Party	
Bluehill Capital Management AG	450,990	272,393

	Service Fees to Related Party	
Bluehill Capital Management AG	683,696	

Entity with significant influence over Bluehill ID

Mountain Partners AG

Mountain Partners AG owns 25.3% (2007: 17.3%) of the ordinary shares in Bluehill ID AG.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Terms and conditions of transactions with related parties

Outstanding balances at the year-end are unsecured, interest free and settlement occurs in cash. There have been no guarantees provided or received for any related party receivables or payables. For the year ended December 31, 2008, Bluehill ID has not recorded any impairment of receivables relating to amounts owed by related parties (2007: 0). This assessment is undertaken each financial year through examining the financial position of the related party and the market in which the related party operates.

22. Commitments and contingencies

Finance lease

Bluehill ID has finance leases for various items of cars, plant and machinery. Renewals are at the option of the specific entity that holds the lease. Future minimum lease payments under finance leases with the present value of the net minimum lease payments are as follows:

		2008 Present		
	2008		2007	
	Minimum	Value of	Minimum	2007 Present
				Value of
	Payments	Payments	Payments	Payments
			(Unaudited)	
Within one year	569,759	521,280		
After one year but not more than five years	657,141	591,643		
Total minimum lease payments	1,226,900			
Less amounts representing finance charges	113,977			
Present value of minimum lease payments	1,112,923	1,112,923		

23. Financial risk management objectives and policies

Bluehill ID s principal financial liabilities, other than derivatives, comprise loans and borrowings, trade and other payables,. The main purpose of these financial liabilities is to raise finance for Bluehill ID s operations. Bluehill ID has loan and other receivables, trade and other receivables, and cash and short-term deposits that arrive directly from its operations. Bluehill ID also holds quoted financial assets designated as at fair value through profit or loss. Bluehill ID manages the risk and performance of these financial assets by monitoring the fair value. Furthermore, Bluehill ID applies a diversification strategy in the decision process of investing.

Bluehill ID is exposed to market risk, credit risk, currency risk and liquidity risk. Bluehill ID s senior management oversees the management of these risks. Bluehill ID s senior management is supported by a financial risk assistant that advises on financial risks and the appropriate financial risk governance framework for Bluehill ID. The financial risk assistant provides assurance to Bluehill ID s senior management that Bluehill ID s financial risk-taking activities are governed by appropriate policies and procedures and that financial risks are identified, measured and managed in accordance with group policies and group risk appetite. It is Bluehill ID s policy that no trading in derivatives for speculative purposes shall be undertaken. The board of directors reviews and agrees policies for managing each of these risks which are summarised below.

Market risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. Market prices comprise three types of risk: interest rate risk, currency risk and other price risk, such as equity risk. Financial instruments affected by market risk include loans and borrowings, deposits and financial instruments at fair value through profit or loss.

Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Bluehill ID manages its interest rate risk by having a portfolio of fixed

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

rate loans and borrowings mainly. Changes in interest rates have only an immaterial impact on Bluehill ID s profit and equity.

Foreign currency risk

Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Bluehill ID s exposure to the risk of changes in foreign exchange rates relates primarily to Bluehill ID s operating activities (when revenue or expense are denominated in a different currency from Bluehill ID s functional currency) and Bluehill ID s net investments in foreign subsidiaries.

Bluehill ID has not hedged its foreign currency risk in 2008. But Bluehill ID will manage its foreign currency risk by hedging significant transactions that are expected to occur within a maximum 24 month period. It is Bluehill ID s policy to negotiate the terms of the hedge derivatives to match the terms of the hedged item to maximise hedge effectiveness.

The following table demonstrates the sensitivity to a reasonably possible change in the US-Dollar (US$), Canadian Dollar (CAD), Australian Dollar (AUD), Brazil Real (Real $) and Swiss Francs (CHF) exchange rate, with all other variables held constant, of Bluehill ID s profit before tax (due to changes in the fair value of monetary assets and liabilities) and Bluehill ID s equity.

	Change in US$ Rate	Effect on Profit Before Tax	Effect on Equity
2007	+15%		
	−15%		
2008	+15%	5,389	
	−15%	(5,389)	

	Change in CAD Rate	Effect on Profit Before Tax	Effect on Equity
2007	+15%		
	−15%		
2008	+15%	40,931	
	−15%	(40,931)	

	Change in AUD Rate	Effect on Profit Before Tax	Effect on Equity
2007	+20%		
	−20%		

2008	+20%	2,734	
	–20%	(2,734)	

	Change in Real $ Rate	Effect on Profit Before Tax	Effect on Equity
2007	+15%		
	−15%		
2008	+15%	9,759	
	−15%	(9,759)	

	Change in CHF Rate	Effect on Profit Before Tax	Effect on Equity
2007	+10%		
	−10%		
2008	+10%	43,338	
	−10%	(43,338)	

Table of Contents

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Equity price risk

Bluehill ID s listed and unlisted equity securities are susceptible to market price risk arising from uncertainties about future values of the investment securities. Bluehill ID manages the equity price risk through diversification and placing limits on individual and total equity instruments. Reports on the equity portfolio are submitted to Bluehill ID s senior management on a regular basis. Bluehill ID s board of directors reviews and approves all equity investment decisions.

Financial Instruments	**Valuation at December 31**	**Increase of 50% in the Value of the Listed Equity Instrument**	**Effect of the Increase (Unaudited)**	**Decrease of 50% in the Value of the Listed Equity Instrument**	**Effect of the Decrease**
Through profit or loss					
2007					
Listed equity instruments					
Effects on earnings before taxes					
2008					
Listed equity instruments	2,637,801	3,956,702	1,318,901	1,318,901	(1,318,901)
Effects on earnings before taxes			1,318,901		(1,318,901)

At the balance sheet date, the exposure to unlisted equity securities at fair value was 0. At the balance sheet date, the exposure to listed equity securities at fair value was 2,637,801.

Credit risk

Credit risk is the risk that a counterparty will not meet its obligations under a financial instrument or customer contract, leading to a financial loss. Bluehill ID is exposed to credit risk from its operating activities (primarily for trade receivables and loan notes) and from its financing activities, including deposits with banks and financial institutions, foreign exchange transactions and other financial instruments.

Credit risks related to receivables: Customer credit risk is managed by each business unit subject to Bluehill ID s established policy, procedures and control relating to customer credit risk management. Outstanding customer receivables are regularly monitored. The maximum exposure to credit risk at the reporting date is the carrying value of each class of financial assets. Bluehill ID does not hold collateral as security. Credit risk related to financial instruments and cash deposits: credit risk from balances with banks and financial institutions is managed by Group Treasury in accordance with Bluehill ID s policy. Bluehill ID s maximum exposure to credit risk for the components of the balance sheet at December 31, 2008 and 2007 is the carrying amounts as illustrated in Note 12.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Liquidity risk

Bluehill ID monitors its risk to a shortage of funds using a recurring liquidity planning tool. Bluehill ID s objective is to maintain a balance between continuity of funding and flexibility through the use of bank overdrafts, bank loans, finance leases and hire purchase contracts. The table below summarises the maturity profile of Bluehill ID s financial liabilities at December 31, 2008 based on contractual undiscounted payments. The maturity of the financial liabilities for financial lease obligations is disclosed in Note 22.

	Less Than 1 Months	1 to 3 Months	3 to 12 Months	1 to 5 Years	> 5 Years	Total
			(Unaudited)			
Year ended December 31, 2008						
Interest-bearing loans and borrowings	699,172					699,172
Other current financial liabilities			1,376,150			1,376,150
Trade and other payables		1,235,964				1,235,964
Total	699,172	1,235,964	2,375,034			4,310,170
Year ended December 31, 2007						
Interest-bearing loans and borrowings	282,951					282,951
Other current financial liabilities		1,355,035				1,355,035
Total	282,951	1,355,035				1,637,986

Capital management

The primary objective of Bluehill ID s capital management is to ensure that it maintains a strong credit rating and healthy capital ratios in order to support its business and maximise shareholder value.

Bluehill ID uses a defined Intra-Group gearing ratio to manage the structure of the capital. The gearing ratio is the ratio of financial liabilities and equity. In accordance with Bluehill ID s internal agreement the gearing ratio may not excess 50%. The financial liabilities include bank overdrafts, leasing liabilities and interest-bearing borrowings. The equity is the consolidated equity as shown in Note 17.

Bluehill ID manages its capital structure and makes adjustments to it, in light of changes in economic conditions. To maintain or adjust the capital structure, Bluehill ID may adjust the dividend payment to shareholders, return capital to shareholders or issue new shares. No changes were made in the objectives, policies or processes during the years end December 31, 2008 and December 31, 2007.

24. Share-based payment transactions

2,671,230 call options for 2,671,230 shares of Bluehill ID AG are currently issued to service providers as compensation. 1,616,230 call options were issued in the current period (2007: 1,055,000). The strike price of all issued call options is 1 CHF per option. The period of exercising is five years starting from the date of issue. An early exercise of the option is possible anytime (American Options). To attend its option duties (not only for the described options), Bluehill ID AG performed a conditional capital increase. The contract party did not use its options by the closing date. The average value per option is 0.28 (2007: 0.26)

Because the fair value of the received services can not be reliably determined, the fair value of the granted equity instrument is used as a reference. The options are not directly tied to the length of service so the received services are entered at full value with an according change in equity. The fair value of the granted stock options at the time of provision is determined by using a binominal model according to Cox-Ross-Rubinstein.

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Following parameters were used for calculating the value of the call options.

	2008	2007
Period of exercising	5 years	5 years
Volatility	48.11%	45%
Strike price per option	CHF 1	CHF 1
Value of the underlying	CHF 1	CHF 1
Risk-free interest rate	2.745%	3.1%

25. Events after the balance sheet date

25.1 Investments in subsidiaries after the balance sheet date

Syscan ID

In January 2009, Bluehill ID completed a number of transactions that led to the acquisition of the assets of the former Syscan International. The assets in Montreal, Quebec were acquired into a newly created wholly owned subsidiary of named Syscan ID. Syscan ID is a unique animal ID and supply chain solution provider that delivers integrated tracking systems to improve business efficiency through Radio Frequency Identification (RFID).

Fastcards

The shares of Fastcards Pty Ltd have also been acquired and held directly by Bluehill ID AG. Fastcards is an identification technology company focusing on personalization, programming and issuance of ID credentials based in Brisbane, Australia. Fastcards offers a range of services from online express ID cards delivery to customized ID management solutions. The products focus on secure credential management for corporations, governments and events.

Yoonison

Also during the first quarter of 2009, Bluehill ID completed the acquisition of Yoonison B.V in the Netherlands. Yoonison specializes in identification and payment management solutions with a focus on the Dutch and German markets. The company pioneered the Mybility^{tm} system, offering solutions for managing identification and transport payment subsidies for disabled and elderly people in the Netherlands and has been a pioneer in promoting Near Field Communication (NFC) solutions for vending applications.

The purchase price allocations according to IFRS for the acquisitions in 2009 have not yet been completed. The detailed information about assets and liabilities of acquired subsidiaries, and the resulting Goodwill, is therefore provisionally reported.

Cost	Provisional in KEUR

	(Unaudited)
Cash	228
Fair value of shares issued	93
Costs associated with the acquisition	310
Total	631
Cash outflow on acquisition	
Net cash acquired with the subsidiary	(2)
Cash paid	538
Net cash outflow	(540)

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Provisional Fair Value Recognized on Acquisition in KEUR (Unaudited)
Intangible assets	52
Customer lists	236
Property, plants and equipment	972
Financial instruments	
Deferred tax assets	16
Inventories	80
Trade receivables	292
Other assets	94
Cash and cash equivalents	(2)
Total assets	1740
Provisions	89
Trade payables and liabilities	1764
Deferred tax liabilities	203
Total liabilities	2056
Net asset	(316)
Minority interests (0)%	
Total net assets acquired	(316)
Goodwill arising on acquisition	947
Total consideration	631

Disclosures of the carrying amounts of each classes of the acquiree s assets and liabilities, determined in accordance with IFRS, immediately before the combination are impracticable. The acquired companies are unlisted small and medium-sized companies, which were not able to deliver information in accordance with IFRS.

25.2 Change of corporate structure

The original statutory structure of Bluehill ID AG was that of an investment fund similar to other investment vehicles. Under the original structure, the Founders of the Bluehill ID, Mountain Partners AG and Mr. Ayman S. Ashour offered management services to Bluehill ID AG through a privately held management company, namely Bluehill Capital Management AG. Bluehill Capital Management AG has been compensated for its services through management & success fees and annual option grants. In addition Bluehill Capital Management AG has had the right to name the majority of the directors of the board. The Founders received no Founders shares and remain the largest investors in the company.

With the clear success of Bluehill ID AG in developing into an industrial holding company employing a strategy of buy, build & grow rather than buy & sell , the board of Bluehill ID AG, based on strong recommendations from its management team, its banking and legal advisors, concluded that terminating the management company structure would be in the best interests of all of the stakeholders of Bluehill ID AG.

Accordingly, Bluehill ID AG in 2009 has reached agreement to exercise its option to terminate the management agreement effective June 30, 2009, and Bluehill Capital Management AG has agreed to reinvest CHF 4.2 million of the CHF 5 million termination fee into a convertible loan to Bluehill ID AG. The loan will be convertible at the request of Bluehill Capital Management AG at CHF 2.5 per share and may be converted at the request of Bluehill ID AG at a CHF 1.00 per share or 33% below the average trading price 90 days prior to the conversion. Under the provisions of the termination agreements, Mr. Ayman S. Ashour and Mr. Fabien Nestmann

BLUEHILL ID AG

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

will enter into direct agreements with Bluehill ID AG and Mountain Partners will provide Bluehill ID AG with certain support services for a further limited period until Bluehill ID AG is able to complete the building of its infrastructure.

The agreement between Bluehill ID AG and Bluehill Capital Management AG is subject to the approval of the board of Mountain Partners AG and to the majority of the shareholders of Bluehill ID AG excluding Mountain Partners AG, its affiliates and Mr. Ashour.

26. Board of Directors[2]

Board of directors:

Ayman S. Ashour

Daniel C. Wenzel

Werner Vogt

27. Approval of the Financial Statement

The board of directors reviewed the financial statements on May 15, 2009 and declared its approval.

[2] Bluehill ID AG footnote: *The members of the Statutory board of directors do not receive additional compensation by virtue of membership to the board of the directors. The members of the Advisory Board for Bluehill ID AG consists of Professor Rainer Elschen, Hans-Joachim Filzhuth, Dr. Reinhard Kalla, Phil Libin and André Ziegler. The independent members receive nominal compensation from Bluehill ID AG.*

Multicard AG

INTERIM BALANCE SHEET
(unaudited)
as of June 30, 2008
currency: CHF

ASSETS

A.	**Fixed assets**	**718,713.95**
I.	Intangible fixed assets	53,722.65
II.	Tangible fixed assets	483,595.46
III.	Financial assets	181,395.84
B.	**Current assets**	**788,782.17**
I.	Inventories	25,000.00
II.	Receivables and other assets	
1.	Trade receivables	372,345.33
2.	Other assets	306,644.63
III.	Cash-in-hand, central bank balances, bank balances and checks	84,792.21
C.	**Prepaid expenses**	
D.	**Deficit not covered by equity**	
E.	**Accruals**	**8,306.67**
		CHF 1,515,802.79

EQUITY & LIABILITIES

A.	**Equity**	**195,620.11**
I.	Capital stock	400,000.00
II.	Capital reserve	22,000.00
III.	Profit/Loss brought forward	43,236.26
IV.	Annual net profit/deficit	(269,616.15)
B.	**Accruals**	**196,094.30**
1.	Accrued taxes	39,255.85
2.	Other accruals	156,838.45
C.	**Liabilities**	**1,124,088.38**

1.	Payable to banks	
2.	Advance payments received	
3.	Trade payables	150,563.29
4.	Other Liabilities	973,525.09
	of which lease liabilities:	135,434.53
	of which relating to social security and similar obligations	52,227.84
	of which due within one year:	
		CHF 1,515,802.79

Multicard AG

PROFIT & LOSS ACCOUNT
(unaudited)

as of June 30, 2008
currency: CHF

1.	**Revenues**	**CHF 1,428,920.96**
2.	Increase or reduction of inventory of finished and unfinished products	
3.	Other operating income	
4.	Cost of materials	(600,892.86)
5.	Labor cost	(652,311.59)
6.	Depreciations	(65,771.32)
7.	Other operating expenditure	(377,230.52)
8.	Other interest and similar income	
9.	Interest and similar expenditure	(1,640.32)
10.	**Result of ordinary activities**	**(268,925.65)**
11.	Tax from income and earnings	690.50
12.	**Result**	**CHF (269,616.15)**

Multicard GmbH, VS-Schwenningen

INTERIM BALANCE SHEET
(unaudited)
As of June 30, 2008

	EUR	EUR
ASSETS		
A. Fixed assets		
I. Intangible fixed assets		
1. Concessions, industrial and similar rights and assets, and licenses in such rights and assets		66,956.15
II. Tangible fixed assets		
1. Other equipment, operating and office equipment		23,177.30
B. Current assets		
I. Inventories		
1. Finished goods and merchandise		36,204.67
II. Receivables and other assets		
1. Trade receivables	121,680.70	
2. Other assets	42,387.71	164,068.41
III. Cash-in-hand, central bank balances, bank balances and checks		1,861.09
C. Prepaid expenses		4,152.61
D. Deficit not covered by equity		156,848.66
		453,268.89
EQUITY AND LIABILITIES		
A. Equity		
I. Subscribed capital		30,000.00
II. Accumulated losses brought forward		(81,929.19)
III. Net loss for the fiscal year		(104,919.47)
Deficit not covered by equity		156,848.66
Accounting equity		0.00
B. Provisions		
1. Other provisions		56,720.00
C. Liabilities		
1. Payments received on account of orders	7,475.00	
2. Trade payables	152,228.37	
of which due within one year	152,228.37	
3. Other liabilities	236,845.52	396,548.89
of which taxes	10,247.21	
of which relating to social security and similar obligations	80.00	

of which due within one year	44,970.52	
Total equity and liabilities		453,268.89

TagStar Systems GmbH

INTERIM BALANCE SHEET
(unaudited)
as of June 30, 2008
currency: EUR

ASSETS

A. Fixed assets	**422,180.38**
I. Intangible fixed assets	
1. Concessions, industrial and similar rights and assets, and licenses in such rights and assets	
II. Tangible fixed assets	
1. Technical facility and machinery	59,139.14
2. Other installations, fixtures and furnishing	75,284.92
3. Advance Payments and facilities within the building	35,746.00
III. Financial assets	
1. Holdings in affiliated companies	252,010.32
B. Current assets	**987,449.57**
I. Inventories	491,440.72
II. Receivables and other assets	
1. Trade receivables	123,086.15
2. Other assets	314,123.83
III. Cash-in-hand, central bank balances, bank balances and checks	58,798.87
C. Prepaid expenses	
D. Deficit not covered by equity	
E. Accruals	**79,055.96**
	1,488,685.91

EQUITY & LIABILITIES

A. Equity	**344,664.20**
I. Capital stock	25,000.00

II. Capital reserve	395,000.00
III. Profit/Loss brought forward	292,493.32
IV. Annual net profit/deficit	(367,829.12)
B. Accruals	**188,603.38**
1. Accrued taxes	64,298.00
2. Other accruals	124,305.38
C. Liabilities	**955,418.33**
1. Payable to banks	1,029.62
2. Advance payments received	76,253.32
3. Trade payables	414,851.99
4. Other Liabilities	463,283.40
of which taxes:	313,358.77
of which relating to social security and similar obligations	12,989.13
of which due within one year:	390,336.69
	1,488,685.91

TagStar Systems GmbH

PROFIT & LOSS ACCOUNT

(unaudited)
as of June 30, 2008

currency: EUR

1.	**Revenues**	**EUR 1,423,780.32**
2.	Increase or reduction of inventory of finished and unfinished products	61,785.79
3.	Other operating income	13,871.19
4.	Cost of materials	1,061,146.14
5.	Labor cost	270,757.33
6.	Depreciations	90,652.41
7.	Other operating expenditure	406,371.10
8.	Other interest and similar income	330.55
9.	Interest and similar expenditure	2,765.79
10.	**Result of ordinary activities**	**(331,924.92)**
11.	Tax from income and earnings	35,904.20
12.	**Result**	**EUR (367,829.12)**

Multicard GmbH, VS-Schwenningen

INCOME STATEMENT from January 1, 2008 to June 30, 2008

	EUR	EUR
	(Unaudited)	
1. Gross profit		388,829.74
2. Personnel expenses		
a) Wages and salaries	(235,882.43)	
b) Social security, post-employment and other employee benefit costs	(37,202.26)	
of which in respect of old age pensions	6,952.65	
Total Personnel expenses		(273,084.69)
3. Depreciation, amortization and write-downs		
a) Amortization and write-downs of intangible fixed assets, depreciation and write-downs of tangible fixed assets, and amortization of capitalized business start-up and expansion expenses		(11,095.31)
4. Other operating expenses		(205,707.31)
5. Other interest and similar income		26.50
6. Interest and similar expenses		(3,426.37)
7. Result from ordinary activities		(104,457.44)
8. Taxes on income		0.01
9. Other taxes		(462.04)
10. Net loss for the fiscal year		(104,919.47)

Multicard AG, Wallisellen, Switzerland

Balance Sheet

	December 31, 2008	December 31, 2007
	CO	CO
	CHF	CHF
		(Unaudited)
ASSETS		
Liquid assets	CHF 10,812.68	CHF 5,498.64
Accounts receivable i.r.o. deliveries and services	618,607.55	691,409.85
Del credere reserves	(10,739.60)	(10,000.00)
Other assets	2,454.81	26,671.62
Inventories	51,880.00	65,050.00
Accrued income and prepaid expenses	0.00	5,687.00
Current assets	**673,015.44**	**784,317.11**
Moveable fixed assets	296,276.51	296,700.00
Fixed assets being leased	130,906.85	0.00
Intangible assets	86,521.67	73,400.00
Participating interests	168,030.32	0.00
Loans to associated Companies	151,753.41	0.00
Subordinated loans to associated companies	184,937.50	0.00
Security deposits	34,048.97	34,091.01
Fixed assets	**1,052,475.23**	**404,191.01**
	CHF 1,725,490.67	**CHF 1,188,508.12**
LIABILITIES AND EQUITY:		
Accounts payable i.r.o deliveries and services	283,246.10	536,832.86
Other short-term liabilities	250,125.56	0.00
Loans	168,154.00	99,901.00
Subordinated loans to associated companies	436,455.09	0.00
Accounts payable from leasing obligations	109,763.93	0.00
Accrued expenses and deferred income	17,496.15	86,538.00
Reserves created for warranty obligations	10,000.00	0.00
Borrowed capital	**1,275,240.83**	**723,271.86**
Share capital	400,000.00	400,000.00
Statutory reserves	23,000.00	22,000.00
Re-evaluation IFRS	0.00	0.00
Balance sheet profit	27,249.84	43,236.26
Shareholders equity	**450,249.84**	**465,236.26**
	1,725,490.67	**1,188,508.12**

Multicard AG, Wallisellen, Switzerland

Income statement

	2008 CO CHF	2007 CO CHF
	(Unaudited)	
Income from cards	CHF 1,138,277.50	1,205,371.65
Income from machines	17,348.00	57,416.65
Income from services	1,926,315.15	1,577,990.68
Miscellaneous income	365,353.22	273,496.03
	3,447,293.87	**3,114,275.01**
Costs directly related to sales, cards	(813,698.95)	(772,917.20)
Costs directly related to sales, machines	(9,393.21)	(7,845.41)
Costs related to services	(259,210.00)	(310,595.05)
Various other costs directly related to sales	(176,042.79)	(192,987.17)
Gross profit	**2,188,948.92**	**1,829,930.18**
Sales expenses	(591,136.14)	(28,078.53)
Engineering	(123,773.52)	0.00
Production	(1,008,674.77)	0.00
Administration	(272,413.82)	(107,713.49)
Staff	0.00	(1,186,893.14)
Expenses for premises	0.00	(174,248.56)
Maintenance, leasing	0.00	(204,200.45)
Finance income	22,697.23	2,119.52
Financing expenses	(49,998.28)	(23,444.52)
Depreciation	(146,607.94)	(93,290.75)
Taxes	(1,393.55)	(1,052.60)
Losses on receivables	(2,634.55)	0.00
Provisions	(30,000.00)	0.00
Profit/loss	**CHF (14,986.42)**	**CHF 13,127.66**

Multicard AG, Wallisellen, Switzerland

Appendix to the Annual Financial Statement

	2008 CHF (Unaudited)	2007 CHF
Pledged assets		
Security deposits	34,048	34,091
Leasing obligations not accounted for on the balance sheet	0	66,636
Fire insurance value of property, plant and equipment	1,050,000	1,050,000
Liabilities towards social security institutions	52,980	24,520
Participating interests		
Multicard GmbH, Villingen-Schwenningen		
par. value EUR 30,000, 100%	168,030	0

Information on the implementation of risk evaluation

The board of directors has intermittently carried out adequate risk evaluations and taken all measures derived therefrom in order to ensure that the risk of a material misstatement in the financial reporting would be classified as minor.

Other information

Due to changes in the accounts structure, the figures for the previous year are comparable to a limited extent only.

Further statutory information pursuant to Art. 663b Swiss Code of Obligations is not required.

Multicard AG, Wallisellen, Switzerland

Proposal for Appropriation of the Balance Sheet Profit of 2008

	(Unaudited) CHF
Available to the general shareholders meeting:	
Balance sheet profit per January 1, 2008	42,236.26
Losses 2008	(14,986.42)
	27,249.84

	CHF
The board of directors proposes the following appropriation of profit:	
Balance brought forward	**27,249.84**

Table of Contents

MULTICARD AG, WALLISELLEN, SWITZERLAND

ADDITIONAL NOTE TO THE FINANCIAL STATEMENTS

These financial statements have been prepared in accordance with accounting principles generally accepted in Switzerland for unlisted companies (Swiss GAAP) and the Company s articles of association. Accounting principles that are mandatory for listed companies in Switzerland (Swiss GAAP FER) have not been applied.

The following is a narrative summary of material differences regarding the form, content and accounting principles that exist between the Swiss GAAP regulations and accounting principles generally accepted in the United States of America (US GAAP).

The income statement under Swiss GAAP has been prepared using the type-of-expenditure format. Income and expense items are disclosed according to their type, irrespective of where they are incurred, and include the complete period expenses instead of cost of sales. Under Swiss GAAP unrealized losses have to be recognized while unrealized gains must not be recognized. Assets on the balance sheet are shown according to decreasing liquidity, i.e. highly liquid assets are shown on top of the balance sheet whereas fixed assets are shown on the bottom of the balance sheet. The same reporting principle applies to liabilities and equity.

Under Swiss GAAP the Company is not obliged to present cash flow statements or equity reconciliation statements. Also, the Company is only required to report limited disclosures in the notes to financial statements. Compared to requirements under US GAAP, information in the Swiss GAAP notes to financial statements are less detailed.

The following is a narrative summary of material accounting differences between Swiss GAAP and US GAAP:

Leasing: Under Swiss GAAP, leasing contracts often only require the disclosure of the future lease payments in the notes to financial statements (Sec. 663b Obligationenrecht Swiss GAAP). In most cases lease contracts under Swiss GAAP do not require the lessee to capitalize leased assets. The US GAAP rules are more detailed than under Swiss GAAP. In many cases, leases are accounted for as capital lease under US GAAP that would qualify as operating leases under Swiss GAAP.

Pensions: The Swiss regulations for pension accounting are based on general rules based on Art. 660 et. seq. Obligationenrecht Swiss GAAP. Under US GAAP pension obligations are measured using estimated future compensation levels and estimated periods of employee service based on the projected unit credit method. The discount rate used for US GAAP is based on comparable market rates. Pension obligations determined under US GAAP tend to be significantly in excess of pension obligations determined under Swiss GAAP.

Deferred Taxation: The concept followed under Swiss GAAP is the timing concept and the deferral method accordingly deferred taxes are recorded only for timing differences between taxable income and income in the commercial accounts. Under US GAAP deferred tax liabilities and assets are based on the differences between the tax and accounting basis of assets and liabilities. Therefore, US GAAP deferred tax accounting is more comprehensive than under Swiss GAAP.

MULTICARD GMBH, VS-SCHWENNINGEN

BALANCE SHEET
As of December 31, 2008

	Current Fiscal Year (EUR) (Unaudited)	Previous Fiscal Year (EUR)
ASSETS		
A. Fixed assets:		
I. Intangible fixed assets		
1. Concessions, industrial and similar rights and assets, and licenses in such rights and assets	20,674.00	48,548.00
II. Tangible fixed assets		
1. Other equipment, operating and office equipment	88,069.15	23,991.00
B. Current assets:		
I. Inventories		
1. Work in progress	0.00	266,038.00
2. Finished goods and merchandise	47,949.90	15,124.74
	47,949.90	281,162.74
II. Receivables and other assets		
1. Trade receivables	343,077.52	216,183.11
2. Other assets	2,059.78	52,453.10
	345,137.30	268,636.21
III. Cash-in-hand, central bank balances, and checks	108.84	151,870.47
C. Prepaid expenses	5,706.75	3,405.14
D. Deficit not covered by equity	153,190.05	51,929.19
Total assets	660,835.99	829,542.75
EQUITY AND LIABILITIES		
A. Equity		
I. Subscribed capital	30,000.00	30,000.00
II. Accumulated losses brought forward	(152,761.10)	(5,692.34)
III. Net loss for the fiscal year	(30,428.95)	(76,236.85)
Deficit not covered by equity	153,190.05	51,929.19
Accounting equity	0.00	0.00
B. Provisions		

1. Other provisions	35,827.48	9,400.00
C. Liabilities		
1 .Liabilities to Banks	4,527.13	0.00
of which due within one year	4,527.13	0.00
2. Payments received on account of orders	0.00	250,666.84
of which due within one year	0.00	250,666.84
3. Trade payables	217,982.15	406,921.80
of which due within one year	217,982.15	406,921.80
4. Liabilities to affiliated companies	0.00	57,859.81
of which due within one year	0.00	57,859.81
5. Other liabilities	384,715.90	104,694.30
of which taxes	43,041.01	13,467.68
of which due within one year	45,128.09	104,694.30
	607,225.18	820,142.75
D. Deferred Income	17,783.33	0.00
Total equity and liabilities	660,835.99	829,542.75

MULTICARD GMBH, VS-SCHWENNINGEN

INCOME STATEMENT
From January 1, 2008 to December 31, 2008

	%	Current Fiscal Year (EUR)	Previous Fiscal Year (EUR)
		(Unaudited)	
1. Gross profit	100.00	859,977.03	456,284.17
2. Personnel expenses			
a) Wages and salaries		(477,876.21)	(288,052.80)
b) Social security, post-employment and other employee benefit costs		(70,751.68)	(36,433.56)
	(63.80)	(548,627.89)	(324,486.36)
of which in respect of old age pensions:		(10,957.69)	(2,477.81)
3. Depreciation, amortization and write-downs			
a) Amortization and write-downs of intangible fixed assets, depreciation and write-downs of tangible fixed assets, and amortization of capitalized business start-up and expansion expenses	(3.18)	(27,309.13)	(13,687.05)
4. Other operating expenses	(34.88)	(299,961.90)	(191,439.43)
5. Other interest and similar income	0.01	64.40	76.54
6. Interest and similar expenses	(1.60)	(13,775.43)	(1,665.33)
7. Result from ordinary activities	(3.45)	(29,632.92)	(74,917.46)
8. Taxes on income		(0.03)	0.00
9. Other taxes	(0.09)	(796.00)	(1,319.39)
10. Net loss for the fiscal year	(3.54)	(30,428.95)	(76,236.85)

MULTICARD GMBH, VILLINGEN-SCHWENNINGEN, GERMANY

ADDITIONAL NOTE TO THE FINANCIAL STATEMENTS

These financial statements have been prepared in accordance with Secs. 242 et seq. and Secs. 264 et seq. HGB [Handelsgesetzbuch : German Commercial Code] as well as in accordance with the relevant provisions of the GmbHG [Gesetz betreffend die Gesellschaften mit beschränkter Haftung : German Limited Liability Companies Act] and the Company s articles of incorporation and bylaws. The Company is subject to the requirements for small corporations, as defined by the German Commercial Code. The following is a narrative summary of material differences regarding the form, content and accounting principles that exist between the applied accounting principles generally accepted in Germany (German GAAP) and US GAAP.

The income statement under German GAAP has been prepared using the type-of-expenditure format. Income and expense items are disclosed according to their type, irrespective of where they are incurred, and include the complete period expenses instead of cost of sales. Under German GAAP unrealized losses have to be recognized while unrealized gains must not be recognized.

Assets on the balance sheet are shown according to increasing liquidity, i.e. highly liquid assets are shown on the bottom of the balance sheet whereas fixed assets are shown on top of the balance sheet. The same rational applies to liabilities and equity side of the balance sheet.

Under German GAAP the Company is not obliged to present cash flow statements or equity reconciliation statements. Also, the Company is only obliged to report limited disclosures in the notes to financial statements. Compared to requirements under US GAAP, information in the German GAAP notes to financial statements are far less detailed.

The following is a narrative summary of material accounting differences between German GAAP and US GAAP:

> *Goodwill:* German GAAP allows based on German tax regulations the capitalization for purchased Goodwill items with a useful life of 15 years. Under US GAAP these items have to be amortized over the estimated useful life. This estimation can differ from the 15 year period which has to be applied for German GAAP.
>
> *Leasing:* Under German GAAP, the accounting for leases closely follows tax regulations. A capital lease of a moveable asset is assumed if the basic lease term is less than 40% or more than 90% of the asset s useful life, or if bargain purchase or prolongation options have been agreed. The US GAAP rules are more detailed. In some cases, leases are accounted for as capital lease under US GAAP that would qualify as operating leases under German GAAP.
>
> *Deferred Taxation:* The concept followed under German GAAP is the timing concept and the deferral method accordingly deferred taxes are recorded only for timing differences between taxable income and income in the commercial accounts. Under US GAAP deferred tax liabilities and assets are recorded on the basis of the liability method for the tax effects of almost all differences between the tax and accounting basis of assets and liabilities.

TAGSTAR SYSTEMS GMBH Development of microelectronic components, Sauerlach

BALANCE SHEET
As of December 31, 2008

	Current Business Year (EUR) (Unaudited)	Year Before (EUR)
ASSETS		
A. Fixed assets:		
I. Tangible fixed assets		
1. Technical assets and machinery	125,753.60	84,081.83
2. Other assets, fixtures and furnishings	66,370.08	84,349.57
	192,123.68	168,431.40
II. Financial assets		
1. Participations	252,010.32	252,010.32
B. Current assets:		
I. Inventories		
1. Raw materials and supplies	320,776.83	403,991.25
2. Finished products and goods	136,223.43	97,378.81
3. Advance payments received	43,500.00	43,500.00
	500,500.26	544,870.06
II. Receivables and other assets		
1. Trade receivables	484,997.15	458,412.23
2. Other assets	186,442.06	117,154.21
	671,439.21	575,566.44
III. Cash balance, credit balance with German Federal Bank, credit balance with banks and cheques	85,299.59	50,167.69
C. Accruals	51,166.52	105,351.04
Total assets	1,752,539.58	1,696,396.95
EQUITY AND LIABILITIES		
A. Equity		
I. Subscribed capital	25,000.00	25,000.00
II. Capital reserves	395,000.00	395,000.00
III. Profit brought forward	292,493.32	70,295.50

IV. Annual deficit	(223,293.90)	222,197.82
B. Accruals		
1. Tax accruals	0.00	111,117.00
1. Other accruals	77,600.00	117,300.00
	77,600.00	228,417.00
C. Liabilities		
1. Liabilities due to banks	0.00	1,205.48
of which amounts due in more than one year	0.00	1,205.48
2. Advance payments received on orders	69,355.37	152,372.42
of which amounts due in more than one year	69,355.37	152,372.42
3. Liabilities from deliveries and services	787,603.67	511,467.28
of which amounts due in more than one year	787,603.67	511,467.28
4. Other liabilities	328,781.12	90,441.45
of which from tax	118,810.43	78,802.65
of which in respect of social security	8,604.57	10,577.27
of which amounts due in more than one year	328,781.12	90,441.45
Total equity and liabilities	1,752,539.58	1,696,396.95

TagStar Systems GmbH
Development of microelectronic components, Sauerlach

PROFIT AND LOSS ACCOUNT from January 1, 2008 to December 31, 2008

			Business Year	Year Before
		Euro	Euro	Euro
			(Unaudited)	
1.	Revenues		3,897,401.44	7,543,526.57
2.	Increase of inventory of finished and unfinished products		38,844.62	(33,142.34)
3.	Overall performance		3,936,246.06	7,510,384.23
4.	Other Operating Profits			
a)	Income from lowering of lump-sum allowance regarding receivables		0.00	8,306.00
b)	Income from dissolution of accruals		44,809.78	281.91
c)	Other income in respect of ordinary activities		16.91	0.06
			44,826.69	8,587.97
5.	Cost of materials			
a)	Raw materials and supplies and purchased goods		(2,287,712.27)	(5,944,611.46)
b)	Purchased services		(494,304.00)	(70,230.76)
			(2,782,016.21)	(6,014,842.22)
6.	Labor cost			
a)	Wages and salaries		(485,326.13)	(415,207.65)
b)	Social insurance and pension cost		(93,433.12)	(77,939.04)
			(578,759.25)	(493,146.69)
7.	Depreciation and write-down on intangible assets of fixed assets and tangible assets as well as activated expenditure for start-up and business expansion expenses		(54,201.14)	(59,566.02)
8.	Other operating expenses			
a.	Ordinary operating expenses			
	Occupancy Costs		(78,646.90)	(52,729.96)
	Insurance, contributions, dues		(30,201.80)	(22,429.92)
	Repairs and maintenance		(121,513.14)	(107,610.93)
	Advertising and travel expenses		(74,822.07)	(17,590.03)
	Distribution costs		(28,986.11)	(71,249.31)
	Various operating costs		(522,867.85)	(314,958.28)
b)	Losses from depreciation or from divestiture of items of current assets and transfers to depreciation of receivables		0.00	(13,743.81)
c)	Other expenditure in respect of ordinary activities		(29,170.52)	(0.05)
			(886,208.39)	(600,312.29)
9.	Other interest and similar income		973.98	1,328.08

10.	Interest and similar expenditure	(7,444.22)	(692.11)
	of which to affiliated companies	4,454.43	0.00
11.	Result of ordinary activities	(326,582.48)	351,740.95
12.	Extraordinary revenues	23,563.00	0.00
13.	Extraordinary result	23,563.00	0.00
14.	Tax from income and from revenue	79,725.58	(129,543.13)
15.	Annual deficit	(223,293.90)	222,197.82

TagStar Systems GmbH, Sauerlach

Appendix to Annual Statement of Account for the year ended December 31, 2008

I. GENERAL STATEMENTS

1. *Annual Accounts*

The Annual Statement of Account was produced on the basis of current legal standards. There has been no change in form or layout with regard to the statement of the previous year.

2. *Methods of balancing and valuation*

Valuations of the business year s opening balance sheet agree with those of the previous business year s closing balance sheet.

Methods of balancing and valuation comply with the standards of balancing and assessment of the Code of Commerce (HGB) and have been aligned throughout with the regulations relative to income tax.

An assumption in the valuation was that the company activity will continue. There is no conflict in this regard with real and legal conditions.

Items of fixed assets were balanced at purchasing or manufacturing costs. Increases were depreciated in linear fashion according to ascertained service life based on tax principles. Depreciations on old inventory continue to be made. In the year of addition, moveable items of fixed assets up to a value of 150.00 per individual case were written off in the full amount according to § 6 para 2 income tax law. For capital assets whose value in individual cases exceeds 150.00 but not 1,000.00 a compound item has been formed according to § 6 para 2a income tax law which has been dissolved with one fifth, thus decreasing the profit.

Valuation of finished products and goods or raw materials and supplies, respectively, was made at purchasing costs, as indicated by the client. While taking the necessary fixed costs into account, all work in progress was stated on the balance sheet, according to information provided by the society, with production costs according to § 255 para 2 sentence 2 Commercial Code. The principle at the lower of cost or market was allowed for.

Possible non-payment risks among receivables from deliveries and services have been allowed for by making commensurate specific provisions.

Provisions of an appropriate amount were made for warranty risks, taking the level of turnover, fraught with risk, into account.

Liabilities were stated on the balance sheet in the amount to be repaid, all of them with a remaining period of up to one year.

Liabilities towards shareholders stood at 200,000.00.

3. *Other Statements*

The company was founded per notarial contract dtd. April 9, 2003. The company s entry in the companies register at the Munich local court took place on October 10, 2003, recorded under Department B no. 149483.

The articles were amended per notarial contract dtd. October 17, 2003. Ever since the company has signed with TagStar Systems GmbH, the company s headquarters were in Dietramszell. On October 25, 2007 the Company General Meeting decided to relocate the headquarters to Sauerlach, in the administrative district of Munich.

The company s business year is the calendar year.

The corporate purpose is the development and production of microelectronic components and pertaining software as well as trading with such products, including the provision of product related services.

During the past business year Mr Michael Kober, certified engineer, administered the business on his own. He is exempt from restrictions to undertake legal business with himself or as a representative of third parties.

No advance payments or loans were granted to board members.

TAGSTAR GMBH, SAUERLACH, GERMANY

ADDITIONAL NOTE TO THE FINANCIAL STATEMENTS

These financial statements have been prepared in accordance with Secs. 242 et seq. and Secs. 264 et seq. HGB [Handelsgesetzbuch : German Commercial Code] as well as in accordance with the relevant provisions of the GmbHG [Gesetz betreffend die Gesellschaften mit beschränkter Haftung : German Limited Liability Companies Act] and the Company s articles of incorporation and bylaws. The Company is subject to the requirements for small corporations, , as defined by the German Commercial Code.

The following is a narrative summary of material differences regarding the form, content and accounting principles that exist between the applied accounting principles generally accepted in Germany (German GAAP) and US GAAP.

The income statement under German GAAP has been prepared using the type-of-expenditure format. Income and expense items are disclosed according to their type, irrespective of where they are incurred, and include the complete period expenses instead of cost of sales.

Assets on the balance sheet are shown according to increasing liquidity, i.e. highly liquid assets are shown on the bottom of the balance sheet whereas fixed assets are shown on top of the balance sheet. The same rational applies to liabilities and equity side of the balance sheet.

Under German GAAP the Company is not obliged to present cash flow statements or equity reconciliation statements. Also, the Company is only obliged to report limited disclosures in the notes to financial statements. Compared to requirements under US GAAP, information in the German GAAP notes to financial statements are far less detailed.

The following is a narrative summary of material accounting differences between German GAAP and US GAAP:

> *Intangible Assets:* Under German GAAP it is not allowed to capitalize own development expenses. US GAAP allows to capitalize own development expenses if certain criteria are met. Therefore, under US GAAP intangible assets from capitalized development expenses are higher than under German GAAP.
>
> *Leasing:* Under German GAAP the accounting for leases closely follows tax regulations. A capital lease or a moveable asset is assumed if the basic lease term is less than 40% or more than 90% of the asset s useful life, or if bargain purchase or prolongation options have been agreed. The US GAAP rules are more detailed. In some cases leases are accounted for as capital lease under US GAAP that would qualify as operating leases under German GAAP.
>
> *Deferred Taxation:* The concept followed under German GAAP is the timing concept and the deferral method accordingly deferred taxes are recorded only for timing differences between taxable income and income in the commercial accounts. Under US GAAP deferred tax liabilities and assets are recorded on the basis of the liability method for the tax effects of almost all differences between the tax and accounting basis of assets and liabilities.

Bluehill ID AG

Interim consolidated statement of financial positions as of June 30, 2009

	June 30, 2009 EUR	December 31, 2008 EUR
	(Unaudited)	
Assets		
Non-current assets		
Property, plant and equipment	2,754,779	1,577,136
Intangible assets	8,462,092	7,083,142
Non-current investments in listed equity instruments and loans	4,825,539	3,405,472
Deferred tax assets	147,576	98,061
	16,189,987	12,163,810
Current assets		
Inventories	1,344,057	1,481,463
Trade and other receivables	2,790,671	2,829,321
Cash and short-term deposits	3,200,194	7,725,298
Accrued assets	272,943	71,038
	7,607,865	12,107,120
Total assets	**23,797,852**	**24,270,931**
Equity and liabilities		
Equity attributable to equity holders of the parent		
Issued Capital	17,119,353	16,418,986
Deduction for own shares	(994,117)	0
Share premium	4,920,378	1,521,645
Currency translation reserve	102,291	(111,353)
Accumulated losses	(5,605,606)	(182,758)
	15,542,298	17,646,520
Equity attributable to minority interest		
Minority interest	(10,239)	(10,239)
	(10,239)	(10,239)
Total equity	15,532,059	17,636,281
Non-current liabilities		
Obligations under finance lease contracts	895,105	1,112,923
Provisions due to pensions	181,807	0
Other liabilities	174,663	0
Deferred tax liability	695,336	224,084
	1,946,911	1,337,007
Current liabilities		
Trade and other payables	1,895,090	2,234,848

Interest-bearing loans and borrowings	854,388	699,172
Liabilities from outstanding payments due to acquisitions	1,181,501	1,376,150
Liabilities due to termination agreement	524,432	0
Accrued liabilities	1,057,002	658,405
Provisions	806,469	263,295
Current tax payables	0	65,773
	6,318,882	5,297,642
Total liabilities	8,265,793	6,634,650
Total equity and liabilities	**23,797,852**	**24,270,931**

Bluehill ID AG

Interim consolidated statement of comprehensive income for the six months ended June 30, 2009

(unaudited)	January 1 to June 30, 2009 EUR	January 1 to June 30, 2008 (Restated) EUR
	(Unaudited)	
Profit for the period	(5,422,849)	(354,490)
Exchange differences on translation for foreign Operations	213,644	0
	(5,209,205)	(354,490)
Expenses from issuing new shares directly recognized in equity	(13846)	(68541)
Income Tax	0	0
Total comprehensive income for the period, net of tax	(5,223,051)	(423,031)
Attributable to:		
Equity holders of Bluehill ID AG	(5,217,942)	(423,031)
Minority interests	(5,110)	0
	(5,223,051)	(423,031)

Table of Contents

Bluehill ID AG

Interim consolidated statement of changes in equity for the six months ended June 30, 2009

	Issued Capital EUR	Share Premium EUR	Currency Translation Reserve EUR	Accumulated Losses EUR	Deduction for Own Shares EUR	Equity Attributable to Shareholders of Bluehill ID AG EUR	Minority Interests EUR	Total Equit EUR
				(Unaudited)				
ce at ary 1, 2008	**6,362,755**	**272,393**		**(653,322)**		**5,981,826**		**5,981**
rofit of the l				(354,490)		(354,490)		(354
ses recognized y in equity		(112,951)				(112,951)		(112
e(+)/loss(−) for l		(112,951)		(354,490)		(467,441)		(467
of new shares	7,121,003					7,121,003		7,121
-based payment		200,646				200,646		200
ce at June 30,	**13,483,758**	**360,088**		**(1,007,812)**		**12,836,034**		**12,836**
ce at ary 1, 2009	**16,418,986**	**1,521,645**	**(111,353)**	**(182,757)**		**17,646,521**	**(10,239)**	**17,636**
ncy translation ments			213,644					213
rofit of the l				(5,417,739)		(5,417,739)	(5,110)	(5,422
ses recognized y in equity		(13,846)				(13,846)		(13
e(+)/loss(−) for l		(13,846)	213,644	(5,417,739)		(5,217,941)	(5,110)	(5,223
of new shares	700,367	135,986				836,353		836
			2,753,268			2,753,268		2,753
shares					(994,117)	(994,117)		(994
ges in other es		(51,804)				(51,804)		(51
-based payment		575,129				575,129		575
ce at June 30,	**17,119,353**	**4,920,378**	**102,291**	**(5,600,496)**	**(994,117)**	**15,547,408**	**(15,349)**	**15,532**

Bluehill ID AG

Interim consolidated cash flow statement
for the six months ended June 30, 2009

	January 1 to June 30, 2009 EUR	January 1 to June 30, 2008 EUR
	(Unaudited)	
Operating activities Profit(+)/Loss(−) after tax	(5,422,849)	(198,254)
Adjustment to reconcile profit after tax to net cash flows from operating activities		
Non-cash		
Depreciation and impairment of property, plant and equipment	329,411	0
Appreciation of property, plant and equipment	(132,751)	0
Excess of acquirer s interest in the fair value of net asset	(466,602)	0
Finance income	(197,376)	(317,401)
Finance cost	320,361	233,730
Increase(−)/Decrease(+) in deferred tax assets	(49,515)	0
Increase(+)/Decrease(−) in deferred tax liabilities	471,252	0
Share-based payments expense(+)	575,129	0
Increase(−)/Decrease(+) in Inventories	(37,582)	0
Increase(−)/Decrease(+) in trade and other receivables	38,651	0
Expenses from termination agreement	3,277,700	0
Non cash administrative expenses	27,636	0
Increase(+)/Decrease(−) in trade and other payables	(339,758)	(1,609,705)
Increase(+)/Decrease(−) of interest bearing loans	155,216	0
Increase(+)/Decrease(−) of liabilities due to outstanding payments for acquisitions	(112,472)	0
Increase(+)/Decrease(−) of deferred revenues	398,597	0
Increase(+)/Decrease(−) of provisions	381,117	0
Increase(+)/Decrease(−) current tax payables	(65,773	0
Increase(+)/Decrease(−) of pensions	(181,807)	0
Increase(+)/Decrease(−) other liabilities	174,663	0
Increase(+)/Decrease(−) liabilities due to Termination Agreement	524,432	0
Increase(+)/Decrease(−) accrued assets	(26,918)	120,736
Net cash flows from operating activities	(359,238)	(1,770,895)
Investing activities		
Purchase of property, plant and equipment	(1,177,643)	0
Purchase of Intangibles	(2,175,436)	0
Purchase of financial instruments*	(1,420,067)	(4,193,082)
Net cash flow used in investing activities	(4,773,146)	(4,193,082)
Financing activities		
Transaction costs of issues of shares	0	(44,411)

Proceeds from issuing of new shares	825,099	7,121,003
Repayment of borrowings	0	(3,054,989)
Obligations under finance lease contracts	(217,818)	0
Net cash flow provided by financing activities	607,281	4,021,604
Net increase in cash and cash equivalents	(4,525,103)	(1,942,373)
Net foreign exchange difference	5,327	0
Cash and cash equivalents at January 1	7,725,297	6,433,239
Cash and cash equivalents at June 30	3,200,194	4,490,866

* **The purchases of financial instruments includes cash, which was paid for equity instruments that are not subsidiaries.**

Bluehill ID AG

Interim consolidated income statement for the six months ended June 30, 2009

	January 1 to	January 1 to
	June 30,	
(unaudited)	2009	June 30, 2008
	EUR	EUR
	(Unaudited)	
Operations		
Sale of goods	6,836,543	0
Revenues from Rental and Services	180,670	0
Revenue	**7,017,212**	**0**
Cost of sales	(3,979,785)	0
Gross profit	**3,037,428**	**0**
Other income	175,800	0
Reversal of impairment	132,751	0
Excess of acquirer s interest in the fair value of net assets	466,602	0
Administrative expenses	(1,814,002)	(558,201)
Expenses due to share based payments	(575,129)	0
Expenses from termination agreement	(3,277,700)	0
Depreciation and amortization	(329,411)	0
Salaries, wages and social expenses	(2,321,320)	0
Distribution costs	(584,916)	0
Other expenses	(83,777)	(3,153)
Operating profit	**(5,173,675)**	**(561,354)**
Finance costs	(320,259)	(243,679)
Finance income	197,376	450,543
Profit(+)/Loss(−) before tax (EBT)	**(5,296,558)**	**(354,490)**
Income tax expense	(126,292)	0
Profit(+)/Loss(−) for the year	**(5,422,849)**	**(354,490)**
Attributable to:		
Equity holders of Bluehill ID AG	**(5,417,740)**	**(354,490)**
therefore attributable to minority interests	(5,110)	0
Earnings per share		
Basic earnings per share	(0,202)	(0,025)
Diluted earnings per share	(0,202)	(0,025)
Weighted average number of shares outstanding during the period (undiluted)	26,801,700	13,908,056
Weighted average number of shares outstanding during the period (diluted)	26,801,700	13,908,056

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements

1. Corporate information

Bluehill ID AG is a limited company, incorporated and domiciled in Switzerland whose shares are publicly traded at the Frankfurt Stock exchange. The registered office is located at Dufourstr. 121, St. Gallen, Switzerland. The previous corresponding period contains the period from January 1, 2008 to June 30, 2008.

Bluehill ID companies design, manufacture and sell Radio Frequency Identification (RFID) products and components and other electronic components, and supply cards such as loyalty cards. Such products and components include RFID inlays sold to converters for use in ticketing and label manufacture, RFID and NFC readers sold to customers that have applications requiring the reading of RFID cards and documents, and the supply of customer loyalty cards. Products such as RFID and NFC readers incorporate software and firmware, developed by Group companies, and such software and firmware form an integral part of the reader.

Bluehill ID is focused on building the world s leading group in identification (ID) technology. The company is dedicated to growing the overall ID market and to accelerating the acceptance of innovative technologies across multiple market sectors.

2.1 Basis of preparation

The unaudited interim condensed consolidated financial statements for the six month ended June 30, 2009 have been prepared in accordance with IAS 34 Interim Financial Reporting.

The unaudited interim condensed consolidated financial statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with Bluehill ID s annual financial statements as at December 31, 2008.

The unaudited consolidated financial statements have been prepared on a historical cost basis, except for financial instruments at fair value through profit or loss, that have been measured at fair value. The consolidated financial statements are presented in euros and all values are rounded except when otherwise indicated.

Statement of compliance

The unaudited consolidated financial statements of Bluehill ID have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

Basis of interim condensed consolidation

The unaudited interim consolidated financial statements comprise the financial statements of Bluehill ID AG and its subsidiaries as at June 30, 2009. Subsidiaries are fully consolidated from the date of acquisition, being the date on which Bluehill ID obtains control, and continue to be consolidated until the date that such control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies.

All intra-group balances, income and expenses and unrealized gains and losses resulting from intra-group transactions are eliminated in full.

2.2 Changes in accounting policy and disclosures

The accounting policies adopted in the preparation of the unaudited interim condensed consolidated financial statements are consistent with those followed in the preparation of Bluehill ID s annual financial statements for the

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

year ended December 31, 2008, except for the adoption of new Standards and Interpretations as of January 1, 2009, noted below:

IFRS 2 Share-based Payment Vesting Conditions and Cancellations

The Standard has been amended to clarify the definition of vesting conditions and to prescribe the accounting treatment of an award that is effectively cancelled because a non-vesting condition is not satisfied. The adoption of this amendment did not have any impact on the financial position or performance of Bluehill ID.

IFRS 7 Financial Instruments: Disclosures

The amended standard requires additional disclosure about fair value measurement and liquidity risk. Fair value measurements are to be disclosed by source of inputs using a three level hierarchy for each class of financial instrument.

IFRS 8 Operating Segments

This standard requires disclosure of information about Bluehill ID s operating segments and replaces the requirement to determine primary (business) and secondary (geographical) reporting segments of Bluehill ID. Adoption of this Standard did not have any effect on the financial position or performance of Bluehill ID.

IAS 1 Revised Presentation of Financial Statements

The revised Standard separates owner and non-owner changes in equity. The statement of changes in equity includes only details of transactions with owners, with non-owner changes in equity presented as a single line. In addition, the Standard introduces the statement of comprehensive income: it presents all items of recognized income and expense, either in one single statement, or in two linked statements. Bluehill ID AG has elected to present two statements.

IAS 23 Borrowing Costs (Revised)

The standard has been revised to require capitalization of borrowing costs on qualifying assets and Bluehill ID has amended its accounting policy accordingly. In accordance with the transitional requirements of the Standard this has been adopted as a prospective change. Therefore, borrowing costs have been capitalized on qualifying assets with a commencement date on or after January 1, 2009. No changes have been made for borrowing costs incurred prior to this date that have been expensed.

IAS 32 Financial Instruments: Presentation and IAS 1 Puttable Financial Instruments and Obligations Arising on Liquidation

The standards have been amended to allow a limited scope exception for puttable financial instruments to be classified as equity if they fulfill a number of specified criteria. The adoption of these amendments did not have any impact on the financial position or performance of Bluehill ID.

Improvements to IFRSs

In May 2008 the Board issued its first omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. There are separate transitional provisions for each standard. The adoption of the following amendments resulted in changes to accounting policies but did not have any impact on the financial positions or performance of Bluehill ID AG.

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

IAS 1 Presentation of Financial Statements

Assets and liabilities classified as held for trading in accordance with IAS 39 Financial Instruments: Recognition and Measurement are not automatically classified as current in the statement of financial position. Bluehill ID amended its accounting policy accordingly and analysed whether Management s expectation of the period of realization of financial assets and liabilities differed from the classification of the instrument. This did not result in any re-classification of financial instruments between current and non-current in the statement of financial position.

IAS 16 Property, Plant and Equipment

Replace the term net selling price with fair value less costs to sell . Bluehill ID amended its accounting policy accordingly, which did not result in any change in the financial position.

IAS 23 Borrowing Costs

The definition of borrowing costs is revised to consolidate the two types of items that are considered components of borrowing costs into one the interest expense calculated using the effective interest rate method calculated in accordance with IAS 39. Bluehill ID has amended its accounting policy accordingly which did not result in any change in its financial position.

IAS 38 Intangible Assets

Expenditure on advertising and promotional activities is recognized as an expense when Bluehill ID either has the right to access the goods or has received the service. This amendment has no impact on Bluehill ID because it does not enter into such promotional activities.

The amendments to the following standards below did not have any impact on the accounting policies, financial position or performance of Bluehill ID:

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

IAS 8 Accounting Policies, Change in Accounting Estimates and Error

IAS 10 Events after the Reporting Period

IAS 16 Property, Plant and Equipment

IAS 18 Revenue

IAS 19 Employee Benefits

IAS 20 Accounting for Government Grants and Disclosures of Government Assistance

IAS 27 Consolidated and Separate Financial Statements

IAS 28 Investment in Associates

IAS 31 Interest in Joint ventures

IAS 34 Interim Financial Reporting

IAS 36 Impairment of Assets

IAS 39 Financial Instruments: Recognition and Measurement

IFRIC 9 Reassessment of Embedded Derivatives and IAS 39 Financial Instruments: Recognition and Measurement

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

IFRIC 16 Hedges of a Net Investment in a Foreign Operation

2.3 Summary of significant adjustments in accounting policies

Intangible assets

The treatment of intangible assets within the Bluehill ID Group is already contained in the consolidated financial statement for the year ended December 31, 2008. The management sees a need to give further explanations for intangible assets that were obtained by acquisition of companies, especially customer lists as well as trademarks and brands.

Customer lists

Customer lists occurred from the acquisition of subsidiaries. The evaluation of such customer lists is an estimation. Bluehill ID estimates a useful live of five to ten years. Due to the characteristics of the customer lists the management has used the diminishing balance method. The change of the amortization method has no impact on Bluehill ID s financial result 2008.

Trademarks and brands

Trademarks and brands occurred from the acquisition of subsidiaries. The evaluation of such Trademarks and brands is an estimation. For trademarks and brands that are planned to be continued and that are calculated within the purchase price allocation there is no regular amortization. The value of trademarks and brands will be tested for impairment annually. Tax amortization benefits are recognized in the calculation by assuming a theoretical annual amortization of 20%. For trademarks and brands that are not planned to be continued the management will capitalize the trademark/brand as it is mentioned above but the intangible asset will be amortized over five years.

For both customer list and trademarks the assumed discount rates are based on the risk-free interest rate of the respective region plus a risk adjustment that is specific to the subsidiary. The assumed growth rate assumptions are based on forecasts for long-term inflation with reference to published industry and economic research. Furthermore, Bluehill ID has used information from market provider to acquire relevant information such as Royalty rates for trademarks.

3. Business combinations and acquisition of minority interests

Acquisitions in 2008/2009

The purchase price allocations shown in the annual report as of year-end 2008 were provisional. In accordance with IFRS 3.45 Bluehill ID AG hereby gives the completed purchase price allocations for the acquisitions in 2008.

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

Acquisitions in 2008

The following table presents the final and the provisional values of the purchase price allocation for the acquisitions in 2008. The differences mainly come from customer lists and trademarks and brands revalued in the process of purchase price allocation.

Cost	**Finalized Values in EUR**	**Provisional Values in EUR**
	(Unaudited)	
Cash	2,009,525	2,009,589
Fair value of shares issued	4,129,977	4,789,955
Costs associated with the acquisition	192,439	282,524
Total	6,331,941	7,082,068
Cash outflow on acquisition		
Net cash acquired with the subsidiary	650,561	767,812
Cash paid	(2,201,964)	(2,144,214)
Net cash outflow	(1,551,403)	(1,376,402)

	Finalised Fair Value Recognized on Acquisition in EUR	**Provisional Fair Value Recognized on Acquisition in EUR**
	(Unaudited)	
Intangible assets	170,144	247,075
Customer list	746,688	859,055
Trademarks and brands	188,284	0
Property, plants and equipment	1,665,488	1,665,488
Financial instruments	2,500	685,066
Deferred tax assets	103,241	16,849
Inventories	1,588,050	1,499,383
Trade receivables	2,643,197	1,987,818
Other assets	365,729	97,798
Cash and cash equivalents	681,628	767,812
Total assets	**8,154,922**	**7,826,344**
Provisions	520,065	531,761
Trade payables and liabilities	6,276,139	5,372,667
Deferred tax liabilities	303,687	222,506

Total liabilities	**7,099,890**	**6,126,934**
Net asset	1,055,031	1,699,410
Minority interests	1,315	10,239
Total net assets acquired	1,055,031	1,709,649
Goodwill arising on acquisition	6,074,682	6,072,098
Excess of acquirer s interest in the fair value of net assets	(796,457)	(699,679)
Total consideration	6,331,941	7,082,068

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

Acquisitions in 2009

Fastcards Pty Limited

On January 31, 2009 the shares of Fastcards Pty Ltd have been acquired and are held directly by Bluehill ID AG. Fastcards is an identification technology company focusing on personalization, programming and issuance of ID credentials based in Brisbane, Australia. Fastcards offers a range of services from online express ID cards delivery to customized ID management solutions. The products focus on secure credential management for corporations, governments and events.

Syscan ID (former 4446691 Canada Inc.)

In January 2009, Bluehill ID completed a number of transactions that led to the acquisition of the assets of the former Syscan International. The assets in Montreal, Quebec were acquired into a newly created wholly owned subsidiary named Syscan ID. Syscan ID is a unique animal ID and supply chain solution provider that delivers integrated tracking systems to improve business efficiency through Radio Frequency Identification (RFID).

Yoonison

In January 2009, Bluehill ID completed the acquisition of Yoonison B.V in the Netherlands. Yoonison specializes in identification and payment management solutions with a focus on the Dutch and German markets. The company pioneered the Mybility^{tm} system, offering solutions for managing identification and transport payment subsidies for disabled and elderly people in the Netherlands and has been a pioneer in promoting Near Field Communication (NFC) solutions for vending applications.

The following table presents the provisional values of the purchase price allocation for the acquisitions in 2009.

Cost	**Provisional Values in EUR (Unaudited)**
Cash	504,998
Fair value of shares issued	49,486
Costs associated with the acquisition	276,900
Earn-out	300,000
Total	1,131,384
Cash outflow on acquisition	
Net cash acquired with the subsidiary	(283,735)
Cash paid	(692,851)
Net cash outflow	(976,585)

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

	Provisional Fair Value Recognized on Acquisition in EUR (unaudited)
Intangible assets	102,494
Customer lists	854,890
Trademarks and brands	765,284
Property, plants and equipment	1,356,398
Financial instruments	0
Deferred tax assets	0
Inventories	218,795
Trade receivables	357,850
Other assets	21,931
Cash and cash equivalents	(283,735)
Total assets	**3,393,906**
Provisions	52,377
Trade payables and liabilities	1,907,409
Deferred tax liabilities	473,579
Total liabilities	**2,433,365**
Net asset	**960,541**
Minority interests (0)%	0
Total net assets acquired	960,541
Goodwill arising on acquisition	346,203
Excess of acquirer s interest in the fair value of net assets	(175,360)
Total consideration	1,131,384

Goodwill is principally related to synergies and other intangible assets not qualifying for separate recognition. Such synergies result principally from production and sale of RFID components and collaborative research and development.

Due to the outcome of some earn-outs not being finalised until 2010, it is possible that the goodwill has to be adjusted in future. Earn-outs are taken into consideration when they are more likely than not.

4. Segment information

For management purposes, the group is organized into two business units based upon their products and services:

1. ID Integration and Services, including credential personalization, fulfillment and issuance, together with ID systems management and engineering services. This segment also includes provision of online and mobile data capture systems for ePassport and other Government ID and corporate ID applications. The segment consists of:

Fastcards

Multicard AG

Multicard GmbH

Yoonison

Table of Contents

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

2. RFID Technology Products including the design, development and sales of RFID inlays. Also included in this segment is the design, development and sales of RFID readers for a wide range of applications including physical and logical access, ticketing, payment government ID and industrial applications. Following investments belong to this segment:

ACiG AG

ACiG Technology Ltda.

Arygon AG

Bluehill Microtech GmbH

Scolis Ltd.

Syscan

Tagstar GmbH

No operating segments have been aggregated to form the above segments. Management monitors the operating results of the business units separately for the purpose of making decisions about resources and performance assessment. Segment performance is evaluated on profit before tax. Bluehill ID s administrative costs are managed on a group level and are not allocated to the operating segments.

Transfer pricing between operating segments are on an arm s-length basis in a manner similar to transactions with third parties.

Operating Segments

The following table presents revenue and profit information regarding Bluehill ID s operating segments for the six months ended June 30, 2009. Bluehill ID has initially divided the business in segments. For that reason comparatives are not available.

Six Months Ended June 30, 2009	ID Integration and Services	RFID Technology Products	Adjustments and Eliminations	Total
		(Unaudited)		
Revenue	3,415,927	3,789,448	(188,163)	7,017,212

Cost of Goods Sold	(1,516,828)	(2,484,112)	21,155	(3,979,785)
Gross Profit on Sales	**1,899,099**	**1,305,337**	(167,008)	**3,037,427**
Overheads incl. prod. & labor cost	(1,718,064)	(1,606,675)		(3,324,740)
Results Segment profit before tax	**181,035**	(301,339)		(287,312)

The following table presents segment assets of Bluehill ID s operating segments as at June 30, 2009 and December 31, 2008:

	ID Integration and Services	**RFID Technology Products**	**Adjustments and Eliminations**	**Total**
		(Unaudited)		
Segment assets At June 30, 2009	**3,548,501**	**5,814,838**	**(452,335)**	**8,911,004**

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

4. Impairments

Goodwill

Goodwill is tested for impairment annually (as at December 31, when the subsidiary has been part of Bluehill ID for at least 12 months) and when circumstances indicate the carrying value may be impaired. Bluehill ID s impairment test for goodwill and intangible assets with indefinite lives is based on value in use calculations that use a discounted cash flow model.

Bluehill ID considers, among others, the significant decrease of revenues and cash flows, change of key personnel and external effects when reviewing for indicators of impairment.

5. Cash and short-term deposits

	June 30,	**December 31,**
	2009	**2008**
	(Unaudited)	
Cash at banks and on hand	3,200,194	7,725,298
Total	**3,200,194**	**7,725,298**

Cash at banks earn interest at floating rates based on daily bank deposit rates.

6. Issued capital and reserves

Authorized shares

	June 30,	**December 31,**
	2009	**2008**
	(Unaudited)	
Ordinary share of CHF 1 each	**27,765,797**	**26,712,297**
Total	**27,765,797**	**26,712,297**

As of June 30, 2009, the authorized share capital was increased by 700,367 by issuing 1,053,500 ordinary shares of CHF 1 each.

Ordinary shares issued and fully paid

	Number of Share	
		(Unaudited)
At December 31, 2008	**26,712,297**	**16,418,986**
Issued on February 6, 2009	1,053,500	700,367
As June 30, 2009	**27,765,797**	**17,119,353**

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

Share Premium

	2008 (Unaudited)
At December 31, 2007	**272,393**
Expenses recognized directly in equity	(517,002)
Deferred taxes on expenses recognized directly in equity	33,806
Issue of new shares	1,281,458
Issued on July 9, 2008	952,165
Issued on December 17, 2008	329,293
Share-based payment	450,990
At December 31, 2008	**1,521,645**

	2009 (Unaudited)
Expenses recognized directly in equity	(13,846)
Deferred taxes on expenses recognized directly in equity	0
Issue of new shares on February 6, 2009	700,367
Own shares	(766,039)
Adjustment for own shares	11,202
Share-based payment	575,129
At June 30, 2009	**2,028,458**

Reserve for own shares

	June 30, 2009 (Unaudited)	December 31, 2008
At January 1	0	0
Own shares	766,039	0
Adjustment for own shares	(11,202)	0
At December 31	**754,837**	**0**

Retained earnings and profit of the period

	June 30, 2009 (Unaudited)	December 31, 2008

At January 1	(182,758)	(653,322)
Profit/loss of the period		470,564
At the end of the respective period		**(182,758)**

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

7. Related party disclosures

The following table provides the total amount of transactions that have been entered into with related parties for the relevant financial year (for information regarding outstanding balances at June 30, 2009 and December 31, 2008):

		Amounts Owed by Related Parties	**Amounts Owed to Related Parties**
		(Unaudited)	
Entity with significant influence over Bluehill ID:			
Mountain Partners AG	June 30, 2009	0	269,481
	December 31, 2008	0	699,172
		Interest received (paid)	**Amounts owed by (to) related parties**
Loans from/to related party			
Bluehill Capital Management AG	June 30, 2009	15,549	(156,244)
	December 31, 2008	24,192	382,547
Mountain Partners AG	June 30, 2009		
	December 31, 2008	9,736	0
Share-based payments to related party			
Bluehill Capital Management AG	June 30, 2009		575,129
	June 30, 2008		450,990
Service fees to related party			
Bluehill Capital Management AG	June 30, 2009		0
	June 30, 2008		683,696

Entity with significant influence over Bluehill ID

Mountain Partners AG
Mountain Partners AG owns 30.3% (December 31, 2008: 25.3%) of the ordinary shares in Bluehill ID AG.

Terms and conditions of transactions with related parties

Outstanding balances at the year-end are unsecured, interest fee and settlement occurs in cash with the exception of the termination agreement with Bluehill Capital Management where part of the settlement occurred in cash and part in Bluehill ID shares. There have been no guarantees provided or received for any related party receivables or payables. As of June 30, 2009, Bluehill ID has not recorded any impairment of receivables relating to amounts owed by related parties (2008:   0). This assessment is undertaken each financial year through examining the financial position of the related party and the market in which the related party operates.

8. Commitments and contingencies

Letter of Intent for the Purchase of Production Machine

On the 28th September 2009, Tagstar Systems GmbH issues a letter of intent to Datacon Technology GmbH relating to the proposed purchase of a Datacon 8800 FC Smart Line machine. The machine is expected for delivery in December 2009. The final approval of the investment and issue of the definitive purchase order is subject to final approval of the Tagstar Systems GmbH shareholders.

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

9. Share-based payment transactions

3,914,790 call options for 3,914,790 shares of Bluehill ID AG are currently issued to service providers as compensation. 1,388,290 call options were issued in the current period (2008: 1,616,230). The strike price of all issued call options is 1 CHF per option. The period of exercising is five years starting from the date of issue. An early exercise of the option is possible anytime (American Options). To attend its option duties (not only for the described options), Bluehill ID AG performed a conditional capital increase. The contract party did not use its options by the closing date. The average value per option is 0.32 (2008: 0.28)

Because the fair value of the received services can not be reliably determined, the fair value of the granted equity instrument is used as a reference. The options are not directly tied to the length of service so the received services are entered at full value with an according change in equity. The fair value of the granted stock options at the time of provision is determined by using a binominal model according to Cox-Ross-Rubinstein.

In addition, Bluehill ID entered into a termination of the Advisory Agreement with Bluehill Capital Management. The Termination agreement contains a delivery of 1,388,290 options of Bluehill ID to Bluehill Capital Management. The options issued due to termination agreement partly replace options that were issued in accordance with the Advisory agreement. Furthermore, the termination agreement contains an adjustment of the duration of the options issued. The duration was increased to five years from the effective date of the termination agreement. This change requires a revaluation of the options using the binomial model. The recalculation related to the issue of the options leads to expenses of 575,129.

The following table shows the history of issued options:

History	Advisory Agreement	Termination Agreement
2007	1,055,000	
2008	710,000	
	155,000	
	440,000	
	166,500	
	144,730 revoked	
2009	105,350 revoked	1,388,290
As of June 30, 2009	**3,914,790**	

Following parameters were used for the calculation of the value of the call options.

	June 30, 2009	2008
Period of exercising	5 years	5 years

Volatility	55%	48.11%
Strike price per option	CHF 1	CHF 1
Value of the underlying	CHF 1	CHF 1
Risk-free interest rate	2.87%	2,745%

The total expenses of the termination agreement are CHF 5,000,000 (3,277,700) which are partly paid in Cash CHF 800,000 (524,432). The remainder CHF 4,200,000 (2,753,268) has been converted into fully paid-up Bluehill ID shares after the release of these statements in September 2009 at a conversion rate of CHF 1.00 per share.

Table of Contents

Bluehill ID AG Group

Notes to Consolidated Interim Financial Statements (Continued)

10. Events after the balance sheet date

Capital increase Bluehill ID AG September 2009

In September 2009, Bluehill ID AG did an ordinary capital increase. In total, 4,258,000 shares were issued at a price of 1 CHF per share. The new issued capital after the capital increase was 32,023,797 shares at a nominal value of 1 CHF each.

SCM Microsystems and Bluehill ID agree to combine in an all share transaction

Bluehill ID AG and SCM Microsystems announced they have entered into an agreement to combine their respective companies, subject to certain regulatory and shareholder approvals.

Under the agreement, SCM will make an offer to the Bluehill ID shareholders to acquire all shares of Bluehill ID. Shareholders of Bluehill ID who accept and tender their shares in the offer are expected to receive 0.52 shares of SCM s common stock for every one share of Bluehill ID. If all of the Bluehill shareholders accept the offer and SCM acquires 100% of the outstanding Bluehill ID shares, approximately 60% of the outstanding shares of the combined company would be held by the current SCM stockholders and approximately 40% of the outstanding shares of the combined company would be held by the current Bluehill ID shareholders. Both companies are focused on access control, identity management and RFID technologies and markets. SCM currently operates under the SCM and Hirsch brands while Bluehill ID currently operates under the Multicard, TagStar, Arygon, Syscan and ACiG brands, all covering the RFID and smart card value chains.

11. Board of Directors

Board of directors:

Ayman S. Ashour

Daniel C. Wenzel

Werner Vogt

Cornelius Boersch

The members of the board of directors do not receive compensation for their function.

SCM MICROSYSTEMS, INC.

UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL INFORMATION

On September 20, 2009, SCM Microsystems, Inc. (SCM or the Company) entered into a Business Combination Agreement (the Business Combination Agreement) with Bluehill ID AG (Bluehill ID), a stock corporation incorporated in Switzerland, to combine their respective companies. The Business Combination Agreement provides for, among other things, the Company to make an offer to the Bluehill ID shareholders to acquire all of the Bluehill ID shares (the Offer), and the issuance of shares of SCM s common stock to Bluehill ID shareholders who accept the Offer. Shareholders of Bluehill ID who accept and tender their shares in the Offer are expected to receive 0.52 shares of SCM s common stock for every one share of Bluehill ID. If all of the Bluehill ID shareholders accept the offer and SCM acquires 100% of the outstanding Bluehill ID shares, approximately 60% of the outstanding shares of the combined company would be held by the current SCM shareholders and approximately 40% of the outstanding shares of the combined company would be held by the current Bluehill ID shareholders. The Offer and other transactions contemplated by the Business Combination Agreement are subject to the satisfaction of several conditions, including the declaration of the Registration Statement s effectiveness by the SEC, the filing of a prospectus which satisfies the requirements of the German Securities Prospectus Act (the German Prospectus) with the German Federal Financial Supervisory Authority (BaFin), the approval of the German Prospectus by BaFin, the approval of the SCM shareholders of the Offer and the issuance of the shares in connection with the Offer, the approval for the listing of the shares on NASDAQ, and that at least 75% of the outstanding Bluehill ID shares are tendered in accordance with the terms of the Offer.

On April 30, 2009, SCM acquired Hirsch Electronics Corporation, a California corporation (Hirsch), pursuant to an Agreement and Plan of Merger (the Merger Agreement) entered into on December 10, 2008 between SCM, Hirsch and two wholly owned subsidiaries of SCM (formed solely for the purposes of effecting the merger). Due to the significance of the Hirsch Merger historical information from both SCM and Hirsch has been separately presented in these pro forma financial statements. Under the terms of the Merger Agreement, through a two-step merger, Hirsch became a new Delaware limited liability company and a wholly owned subsidiary of SCM (the Merger). The Merger was conditioned, among other things, on the Merger Agreement being approved by the shareholder of Hirsch, the stockholders of SCM approving the issuance of shares of SCM s common stock and warrants to purchase SCM common stock in connection with the Merger, and on the shares of SCM common stock and warrants to be issued in the Merger being registered on an effective registration statement and authorized for listing on the NASDAQ. All the conditions of the Merger Agreement were satisfied or waived as of, and the Merger was completed on, April 30, 2009 (the closing date). Regarding any further information of the Hirsch Merger we make reference to the information disclosed in the S-4, 8-K and 10-Q filings.

This unaudited pro forma condensed combined financial data should be read in conjunction with the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations of both SCM s and Bluehill ID s and the historical financial statements and accompanying notes of Bluehill ID (contained elsewhere in this joint proxy statement/information statement and prospectus), and SCM s historical financial statements and accompanying notes (contained elsewhere in this joint proxy statement/information statement and prospectus) and appearing in its historical periodic SEC filings including Forms 10-K and 10-Q. The financial statements of SCM have been prepared in conformity with the accounting principles generally accepted in the United States of America (US GAAP). The financial statements of Bluehill ID have been prepared in conformity IFRS and have been reconciled with US GAAP. The financial statements of Bluehill ID s predecessor companies, which include Multicard GmbH, Multicard AG, and TagStar Systems, (collectively the predecessors) have been prepared on a local basis of accounting that is generally accepted in their respective country of operation. The financial statements of the predecessors have also been reconciled with US GAAP.

The unaudited pro forma condensed combined balance sheet as of June 30, 2009 reflects the acquisition and related events as if they had been consummated on June 30, 2009. The unaudited pro forma condensed combined statements of operations for the year ended December 31, 2008 and the six months ended June 30, 2009 reflect the acquisition and related events as if they had been consummated on January 1, 2008, the beginning of SCM s 2008 fiscal year. The unaudited pro forma financial information is presented for informational purposes only and is not intended to represent or be indicative of the results of operations that would have been achieved if the acquisition had been completed as of the dates indicated, and should not be taken as representative of future consolidated results of operations or financial condition of SCM. Preparation of the unaudited pro forma financial information for all periods presented required management to make certain judgments and estimates to determine the pro forma adjustments such as purchase accounting adjustments. The pro forma financial information is presented assuming acquisition of 100% of the shares of Bluehill ID. The actual acquisition might result in acquiring a lower percentage of the shares of Bluehill ID. In addition, with respect to the unaudited pro forma condensed combined balance sheet at June 30, 2009, management estimated the fair value of Bluehill ID s assets acquired and liabilities assumed as of June 30, 2009, based on the purchase price allocation performed as of the September 20, 2009 Business Combination Agreement signing date.

The unaudited pro forma information does not reflect cost savings, operating synergies or revenue enhancements expected to result from the acquisition or the costs to achieve these cost savings, operating synergies and revenue enhancements.

SCM MICROSYSTEMS, INC.
UNAUDITED PRO FORMA CONDENSED COMBINED BALANCE SHEETS
AS OF JUNE 30, 2009

	SCM	Bluehill ID (Historical)	Combined	Pro Forma Adjustments		Pro Forma Combined
ASSETS						
Current assets:						
Cash and cash equivalents	$ 5,309	$ 4,487	$ 9,796	$		$ 9,796
Accounts receivable, net	9,723	3,040	12,763			12,763
Inventories	7,652	1,884	9,536			9,536
Income taxes receivable	765		765			765
Other current assets	1,521	1,010	2,531			2,531
Total current assets	24,970	10,421	35,391			35,391
Investments	1,674	6,029	7,703	(2,678)	**A**	5,026
Property and equipment, net	1,446	3,467	4,913			4,913
Intangible assets, net	23,017	3,910	26,927			26,927
Goodwill	21,895	7,677	29,572	21,095	**B**	50,666
Other assets	1,211	1,243	2,454			2,454
Total assets	$ 74,213	$ 32,747	$ 106,960	$ 18,417		$ 125,377
LIABILITIES AND STOCKHOLDERS EQUITY						
Current liabilities:						
Notes payable to bank	$ 81	$ 1,198	$ 1,279	$		$ 1,279
Accounts payable	5,713	1,586	7,299			7,299
Liability to related parties	1,030		1,030			1,030
Accrued compensation and related benefits	1,285	2,937	4,222			4,222
Accrued restructuring and other charges	2,254	3,431	5,685			5,685
Accrued royalties	491		491			491
Accrued sales tax related expenses	332		332			332
Other accrued expenses	1,909	1,292	3,201	288	**C**	3,489
Income taxes payable	415		415			415
Total current liabilities	13,510	10,445	23,955	288		24,242
Long-term liability to related parties	8,018		8,018			8,018
Deferred tax liability	4,154	961	5,115			5,115
Long-term income taxes payable	377		377			377

Stockholders equity:					
Common stock	26	24,001	24,027	(23,984) **D**	43
Additional paid-in capital	253,754		253,754	43,526 **E**	297,280
Treasury stock	(2,777)	(1,394)	(4,171)	(2,678) **A**	(6,849)
Accumulated deficit	(205,730)	(1,083)	(206,813)	1,083 **F**	(205,730)
Accumulated other comprehensive income	2,881	(182)	2,699	182 **F**	2,881
Total stockholders equity	48,154	21,342	69,496	18,129	87,625
Total liabilities and stockholders equity	$ 74,213	$ 32,747	$ 106,960	$ 18,417	$ 125,377

See accompanying notes to Unaudited Pro Forma Condensed Combined Financial Statements.

SCM MICROSYSTEMS, INC.
UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENTS OF OPERATIONS
FOR THE YEAR ENDED DECEMBER 31, 2008

				Predecessor					
			Predecessor	**Multicard**	**Predecessor**				
		Bluehill	**Multicard**						
		ID	**AG**	**GmbH**	**Tagstar**	**Combined**			
	SCM/Hirsch								
	Pro						**Pro**		**Pro**
	Forma						**Forma**		**Forma**
	Combined								**Combined**
	I			**(Historical)**			**Adjustments**		**II**
	A	**B**	**C**	**D**	**E**	**F=B+C+D+E**	**G**		**H=A+F+G**
Net revenue	$ 52,059	$ 8,764	$ 1,373	$ 1,022	$ 2,270	$ 13,429	$		$ 65,489
Cost of revenue	28,402	5,746	1,120	722	2,171	9,759	0		38,161
Gross profit	23,657	3,018	253	301	99	3,671	0		27,328
Operating expenses:									
Research and development	7,664	265	64	0	11	340	0		8,004
Selling and marketing	16,354	745	297	258	50	1,350	0		17,704
General and administrative	9,758	4,429	138	200	268	5,036	0		14,794
Amortization of intangibles	663	15	9	1	0	25	35	**G**	723
							40		40
Gain on sale of assets	(1,455)	0		0	0	0	0		(1,455)
Total operating expenses	32,984	5,455	507	459	330	6,751	75		39,810
Gain (loss) from operations	(9,327)	(2,437)	(254)	(158)	(231)	(3,080)	(75)		(12,482)
Loss on equity investments	(256)	0	0	0	0	0	0		(256)
Interest income (expense)	(326)	70	(7)	(15)	(49)	(0)	0		(327)
Foreign currency gains (losses) and other income (expense), net	(2,641)	3,079		24	0	3,102	396	**H**	857

Gain (loss) from continuing operations before income taxes	(12,550)	712	(261)	(150)	(280)	22	321		(12,207)
Benefit (provision) for income taxes	517	5	(1)	(3)	(119)	(118)	15	I	415
Gain (loss) from continuing operations	(12,033)	717	(261)	(153)	(399)	(96)	336		(11,792)
Loss from discontinued operations, net of income taxes	(213)	0	0	0	0	0	0		(213)
Gain on sale of discontinued operations, net of income taxes	589	0	0	0	0	0	0		589
Net income (loss)	$ (11,657)	$ 717	$ (261)	$ (153)	$ (399)	$ (96)	$ 336		$ (11,416)
Basic and diluted loss per share from continuing operations	$ (0.48)								$ (0.28)
Basic and diluted income per share from discontinued operations	$ 0.02								$ 0.01
Basic and diluted net loss per share	$ (0.46)								$ (0.27)
Shares used to compute basic and diluted income (loss) per share	25,154						16,562		41,716

See accompanying Notes to Unaudited Pro Forma Condensed Combined Financial Statements.

Table of Contents

SCM MICROSYSTEMS, INC.
UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENTS OF OPERATIONS
FOR THE SIX MONTHS PERIOD ENDED JUNE 30, 2009

	SCM*	Hirsch**	Hirsch EMEA**	Combined	Pro Forma Adjustments I		Pro Forma Combined I	Bluehill ID Historical	Pro Forma Adjustments II	Pro Forma Combine II
		(Historical)								
t revenue	$ 16,116	$ 6,479	$ 182	$ 22,777	$		$ 22,777	$ 9,288	$	$ 32,06
st of revenue	8,431	3,743	132	12,306	0		12,408	6,783	0	19,19
					102	K			0	
					0				0	
yalties to related ties		199		199	(199)	L	0	0	0	
oss profit	7,685	2,537	50	10,272	97		10,369	2,505	0	12,87
erating expenses:										
search and velopment	2,258	1,451		3,709			3,709	470	0	4,17
ling and rketing	5,982	2,507	82	8,571	0		8,571	1,484	0	10,05
neral and ministrative	4,686	934	10	5,630	0		5,630	7,939	0	13,56
nortization of angibles				0	230	M	230	3	0	23
in on sale of ets	(249)			(249)	0		(249)	0	0	(24
tal operating penses	12,677	4,893	92	17,662	230		17,892	9,896	0	27,78
in (loss) from erations	(4,992)	(2,357)	(42)	(7,390)	(133)		(7,523)	(7,391)	0	(14,91
erest and other ome (expense),	(504)	(44)	(12)	(560)	(290)	N	(850)	(29)	(116)	(99
in (loss) from ntinuing erations before ome taxes	(5,496)	(2,401)	(54)	(7,950)	(423)		(8,373)	(7,420)	(116)	(15,90
nefit (provision) income taxes	1,741	198	0	1,939	(198)	O	1,741	(163)	0	1,57

in (loss) from ntinuing erations	(3,755)	(2,203)	(54)	(6,011)	(621)	(6,632)	(7,583)	(116)	(14,33
ome (loss) from continued erations, net of ome taxes	151	0	0	151	0	151	0	0	15
in on sale of continued erations, net of ome taxes	74	0	0	74	0	74	0	0	7
t income (loss)	$ (3,530)	$ (2,203)	$ (54)	$ (5,786)	$ (621)	$ (6,407)	$ (7,583)	$ (116)	$ (14,10
sic and diluted s per share from ntinuing erations	$ (0.24)					$ (0.26)			$ 0.3
sic and diluted ome per share m discontinued erations	$ 0.02					$ 0.01			$ 0.0
sic and diluted net s per share	$ (0.22)					$ (0.25)			$ 0.3
ares used to npute basic and uted income (loss) share	15,744				9,391	25,154		16,562	41,71

* including Hirsch and Hirsch EMEA starting May 1, 2009

** for the period from January 1 to April 30, 2009

See accompanying Notes to Unaudited Pro Forma Condensed Combined Financial Statements.

SCM MICROSYSTEMS, INC.

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

1. Basis of Presentation

The unaudited pro forma condensed combined financial data was prepared using the purchase method of accounting and was based on the historical financial statements of SCM and Bluehill ID. The purchase method of accounting was based on Statement on Financial Accounting Standard or SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)) issued by the Financial Accounting Statement Board (FASB) in December 2007. The provisions of SFAS No. 141(R) are to be applied prospectively to business combinations with acquisition dates on or after the beginning of an entity s fiscal year that begins on or after December 15, 2008, with early adoption prohibited. We applied the provisions of SFAS No. 141 (R) for the purpose of our pro forma disclosures. SCM s and Bluehill ID s fiscal year end on December 31 of each year.

The unaudited pro forma condensed combined balance sheet as of June 30, 2009 combines the historical SCM balance sheet as of June 30, 2009 and Bluehill ID s balance sheet as of June 30, 2009 as if the acquisition had closed on June 30, 2009. The unaudited pro forma condensed combined statements of operations for the year ended December 31, 2008 and the six months ended June 30, 2009 combine the historical SCM and Bluehill ID statements of operations for their respective twelve months ended fiscal year 2008 and six months ended fiscal year 2009 as if the acquisition had closed on January 1, 2008. The statement of operations of Bluehill ID for the twelve months ended fiscal year 2008 (which include the predecessors for the six month period from January 1, 2008 through June 30, 2008) and six months ended fiscal year 2009 have been regrouped and reclassified to match the groupings of SCM s statement of operations and are prepared in accordance with the recognition, valuation and disclosure principles used by SCM.

Regarding any financial statements and notes included for Hirsch for the year 2008 please refer to the SCM s 8-K/A filing and the 10-Q filing for the second quarter 2009. The results of operations of Hirsch are included in the financial statements of SCM since it was acquired. For the period prior to acquisition, January 1, 2009 to April 30, 2009, the results of operations of Hirsch are presented in the column entitled Hirsch and Hirsch EMEA . Also, pro forma adjustments that cover this period are included in the column Pro Forma Adjustments I .

The financial statements of Bluehill ID are prepared in accordance with IFRS. The 2008 IFRS financial statements are audited based on International Standards on Auditing whereas the 2009 financial statements are unaudited. For the purpose of these pro forma statements Bluehill ID s financial statements have been reconciled to US GAAP. This reconciliation has not been audited. The material US GAAP differences mainly include adjustments for the valuation for leases, pensions and deferred taxes.

Also, Bluehill ID s financial reporting is based in Euro. The income statement for 2008 has been translated to USD by applying the average USD rate for the year 2008 of 1.4788 USD/Euro. For the six months period ended June 30, 2009 an average rate of 1.3236 USD/Euro has been applied. Bluehill ID s balance sheet has been translated by applying the exchange rate as of June 30, 2009 of 1.4020 USD/Euro. The financial statements of Multicard GmbH and TagStar are also based in Euro and have been translated to USD by applying the same exchange rates. Multicard AG s financial reporting is based in CHF and has been translated to USD.

Shareholders of Bluehill ID who accept and tender their shares in the offer are expected to receive 0.52 shares of SCM s common stock for every one share of Bluehill ID. If all of the Bluehill ID shareholders accept the offer and SCM acquired 100% of the outstanding Bluehill ID shares, approximately 60% of the outstanding shares of the combined company would be held by the current SCM stockholders. For the presentation of the pro forma financial statement management has considered an acceptance rate of 100%.

In 2008 and 2009, Bluehill ID completed the following acquisitions:

TagStar GmbH, Germany, June 30, 2008, 100% of the shares

Bluehill Microtech GmbH, Germany, June 30, 2008, 100% of the voting shares

Multicard AG and Multicard GmbH, Switzerland, June 30, 2008, 100% of the voting shares

SCM MICROSYSTEMS, INC.

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

ACiG Technology Ltda., Brazil, September 30, 2008, 100% of the voting shares

ACiG AG, Germany, December 31, 2008, 100% of the voting shares

Arygon AG, Germany, December 31, 2008, 91% of the voting shares

Scolis Ltd, India and Singapore, December 31, 2008, 100% of the voting shares

4446691 Canada Inc., Canada, December 31, 2008, 100% of the voting shares

In 2009 Bluehill ID has acquired the following shares:

Syscan ID, Canada, January 2009, 100% of the shares

Fastcards Pty Ltd, Australia, January 2009, 100% of the shares

Yoonison B.V., Netherlands, January 2009, 100% of the shares

For the purpose of presenting the pro forma statements the financial statements of TagStar GmbH, Multicard GmbH and Multicard AG are included from January 1, 2008 since these companies represent Bluehill ID s predecessor. Accordingly, the TagStar GmbH, Multicard GmbH and Multicard AG financial information is included in the unaudited pro forma condensed combined statements of operations for the year ended December 31, 2008 and the six months ended June 30, 2009 as if the purchase had been consummated on January 1, 2008. All other acquisitions by Bluehill ID as well as the predecessors are included in the financial statements from the date of acquisition.

2. Purchase Price Allocation

On September 20, 2009, SCM entered into a Business Combination Agreement with Bluehill ID to combine their respective companies. The Business Combination Agreement provides for, among other things, the Company to make an offer to the Bluehill ID shareholders to acquire all of the Bluehill ID shares, and the issuance of shares of SCM s common stock to Bluehill ID shareholders who accept the Offer. Shareholders of Bluehill ID who accept and tender their shares in the Offer are expected to receive 0.52 shares of SCM s common stock for every one share of Bluehill ID.

Regarding the purchase price allocation from the Hirsch merger we make reference to SCM s 8-K/A filing and the 10-Q filing for the second quarter 2009.

The Bluehill ID acquisition will be accounted for under the purchase method of accounting under SFAS No. 141(R), and under this method of accounting, the total purchase price for the purpose of these unaudited pro forma financial statements was approximately $43,255 thousand as of the date when the Business Combination Agreement was signed and was calculated as follows:

	Bluehill ID bearer shares	32,023,797
−	Bearer shares in Bluehill ID held in treasury	173,768
=	Bluehill ID bearer shares less treasury shares	31,850,029
*	0.52 exchange rate	
=	SCM shares offered	16,562,015
*	closing price Sept. 21, 2009 of $2.50	
=	Proposed offering price	$ 41,405,038
+	Fair value of Bluehill ID options (estimate)	$ 1,850,293
=	Total purchase consideration	$ 43,255,331

SCM MICROSYSTEMS, INC.

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

As part of the purchase consideration, stock options are also being issued by SCM in exchange for outstanding options held by certain non-employees of Bluehill and have been considered to be part of the purchase price. As the total purchase consideration is dependent on a final valuation of the Bluehill ID options and the closing price of SCM s common stock as of the date of closing of the acquisition, the final total purchase consideration can materially differ from the value estimated for these unaudited pro forma condensed combined financial statements.

The fair value of the shares of SCM common stock to be issued was estimated using the closing price of SCM s common stock on September 21, 2009 (the Business Combination Agreement signing date), or $2.50 per share.

The purchase consideration was allocated based on the estimated fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition. Since Bluehill ID acquired all of its subsidiaries in 2008 and 2009, SCM has preliminarily estimated that the purchase price allocations performed by Bluehill ID in preparing its financial statements and for purposes of complying with IFRS will not be materially different than its own purchase price allocation for purposes of applying SFAS No. 141(R) once the acquisition is completed. Therefore, the difference between the purchase price of $43,255 thousand and the net assets of Bluehill ID of $22,736 thousand, has been completely allocated to goodwill. The income statement as presented in the pro forma financial statements reflects the amortization of all identified intangibles as if the acquisition was consummated on January 1, 2008.

In accordance with the Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, goodwill resulting from business combinations is tested for impairment at least annually (or more frequently if certain indicators are present). In the event that management determines that the value of goodwill has become impaired, the combined company will incur an accounting charge for the amount of impairment during the fiscal quarter in which the determination is made.

3. Pro Forma Adjustments

The accompanying unaudited pro forma condensed combined financial statements have been prepared as if the acquisition was completed on June 30, 2009 for balance sheet purposes and on January 1, 2008 for statement of operations purposes and reflect the following pro forma adjustments:

(A) Adjustment to record the 1,201,004 SCM shares held by Bluehill ID as treasury shares.

(B) Adjustment to record the goodwill resulting from the acquisition ($21,095 thousand, i.e. the difference between the purchase price of $43,255 thousand and the net assets of Bluehill ID of $22,736 thousand) as well as the fair values of the earnout agreements ($575 thousand) that relate to Bluehill s acquisitions of TagStar GmbH, Multicard AG and Multicard GmbH and that have been concluded as 50% cash settlement and 50% settlement with Bluehill ID shares.

(C) Adjustment to record the fair value of earn out agreements. The same amount has been recorded as increase in additional paid in capital since 50% is settled in cash and 50% is settled in shares.

(D) Adjustment to record the common stock increase due to the new shares offered.

(E) Adjustment to record additional paid in capital increase due to the new shares offered.

(F) Adjustment to eliminate Bluehill s historical accumulated deficit and accumulated other comprehensive income.

(G) Adjustment to record amortization of intangible assets for the predecessor companies for the first six months of 2008. The amortization expense relates to customer lists that have been identified in the purchase price allocation of the predecessors. The useful life of the customer lists has been estimated with 5 years.

(H) Adjustment to eliminate a write-off on SCM shares at Bluehill ID level.

SCM MICROSYSTEMS, INC.

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

(I) Adjustment to record deferred tax effects on adjustment (G).

(J) Adjustment to eliminate a write-up on SCM shares at Bluehill ID level.

(K) Adjustment to record amortization of acquisition-related intangible assets (developed technology) of Hirsch.

(L) Adjustment to reduce royalty expense due to recording of liabilities assumed related to royalties payable to related parties during purchase price accounting of Hirsch.

(M) Adjustment to record amortization of acquisition-related intangible assets (customer relationships) of Hirsch.

(N) Adjustment to record interest accretion for royalty liability payable to related parties and to decrease interest income by applying the average rate of return for the respective period to the assumed net decrease in SCM s cash balance used to fund the acquisition of Hirsch.

(O) Adjustment to reflect tax impact from the acquisition of Hirsch for the respective period.

Annex A

Business Combination Agreement
as of 20 September 2009
between

SCM Microsystems, Inc., a corporation incorporated in Delaware, USA, 1900-B Carnegie Avenue, Santa Ana, CA 92705, USA

SCM

and

Bluehill ID AG, a stock corporation incorporated in Switzerland, Dufourstraße 121, 9001 St. Gallen, Switzerland

Bluehill

SCM and Bluehill collectively **Parties** and each a **Party**

Content

Definitions		A-3
List of Exhibits		A-5
1.	**Business rationale of the Transaction**	A-6
2.	**Implementation of the Transaction**	A-6
3.	**Obligation to launch the Offer; publication of launch**	A-8
4.	**Share Exchange Ratio; Share Consideration**	A-8
5.	**Offer Document**	A-9
6.	**Offer Conditions**	A-9
7.	**Recommendation of the Offer by Bluehill**	A-9
8.	**Approval by SCM s stockholders; recommendation by SCM**	A-10
9.	**Representations and warranties**	A-11
10.	**Remedies**	A-13
11.	**Covenants**	A-13
12.	**Listing of New Shares**	A-15
13.	**Exclusivity**	A-15
14.	**Post Closing restructuring**	A-16
15.	**Post Closing corporate governance**	A-16
16.	**Merger control**	A-17
17.	**Termination**	A-17
18.	**Confidentiality; communication**	A-18
19.	**Costs**	A-18
20.	**Notices**	A-18
21.	**Miscellaneous**	A-19

Definitions

Term	Definition
Agreement	means this business combination agreement
BaFin	has the meaning as defined in section 2.1
Best Knowledge	has the meaning as defined in section 9.3
Bluehill	means Bluehill ID AG, a stock corporation incorporated in Switzerland, Dufourstraße 121, 9001 St. Gallen, Switzerland
Bluehill Auditor	means Ernst & Young AG, Zurich, Switzerland
Bluehill Board	has the meaning as defined in recital(C)
Bluehill CEO	means the chief executive officer of Bluehill
Bluehill Direct Participations	has the meaning as defined in section 9.2(h)
Bluehill ESOP	means Bluehill s executive share option plan (ESOP) and Bluehill s executive bonus plan in each case adopted by the Bluehill Board on 16 September 2009 on the basis of the resolutions of the annual general meeting of 25 May 2009 collectively
Bluehill Indirect Participations	has the meaning as defined in section 9.2(h)
Bluehill Recommendation	has the meaning as defined in section 7.2
Bluehill Shares	has the meaning as defined in recital(B)
Breach	has the meaning as defined in section 10.1
Business Day	means a day (other than Saturday or Sunday) on which banks are open for business in New York and Frankfurt am Main
Call Option Agreement	means the call option agreement between Bluehill and BH Capital Management AG of 8 September 2009 granting BH Capital Management AG options for 3,914,790 shares in Bluehill on the basis of the resolutions of the annual general meeting of 25 May 2009
CHF	means Swiss Francs
Closing	means the completion of the acquisition of Bluehill Shares by SCM in exchange for the Share Consideration as a result of the Offer
Closing Date	means the day on which the Closing occurs
Combination	has the meaning as defined in recital(C)
Confidentiality Agreement	means the confidentiality agreement between the Parties dated 3 July 2009
Earn Out Agreement	means a sale and purchase agreement entered into by a Party or any of its Subsidiaries under which a Party or a Subsidiary of a Party, as the case may be, is obliged to issue shares to a third party if certain conditions precedent are met
FSE	

	means the Frankfurt Stock Exchange in Frankfurt/Main, Germany
German Prospectus	has the meaning as defined in section 2.2(b)
Indemnification	has the meaning as defined in section 10.3

Term	Definition
Insolvency	means a state when any of the Parties or any of its Subsidiaries, as the case may be, has stopped or suspended payment of its debts, has become unable to pay its debts or otherwise become insolvent or over-indebted in any jurisdiction
Jupiter	means Jupiter Capital Services GmbH, Munich, Germany
NASDAQ	means the NASDAQ Stock Market s National Market, New York, USA
New Shares	has the meaning as defined in recital(E)
Offer	has the meaning as defined in recital(D)
Offer Conditions	has the meaning as defined in section 6.1
Offer Document	has the meaning as defined in section 2.2(c)
Party	means Bluehill or SCM
Party Group	means a Party and its Subsidiaries, taken as a whole
Proxy Statement	has the meaning as defined in section 2.2(a)
Registration Statement	has the meaning as defined in section 2.2(a)
Relevant Persons	has the meaning as defined in section 9.3
SCM	means SCM Microsystems, Inc., a corporation incorporated in Delaware, USA, 1900-B Carnegie Avenue, Santa Ana, CA 92705, USA
SCM Board	has the meaning as defined in recital(C)
SCM CEO	means the chief executive officer of SCM
SCM Direct Participations	has the meaning as defined in section 9.1(h)
SCM Indirect Participations	has the meaning as defined in section 9.1(h)
SCM Recommendation	has the meaning as defined in section 8.2
SEC	has the meaning as defined in section 2.1
Share Consideration	has the meaning as defined in section 4.2
Share Exchange Ratio	has the meaning as defined in section 4.2
Signing Date	means the date on which this Agreement is signed by the Parties
Subsidiary	means any corporation, partnership, joint venture, limited liability company, association or unincorporated organisation which is directly or indirectly controlled by a Party or is under common control by a Party and a third party; for the purpose of this definition, the term control means the power to direct an entity, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise; and the term controlled has the meaning correlative to the foregoing
Superior Offer	has the meaning as defined in section 7.4
Termination Event	has the meaning as defined in section 17.1
Transaction	means this Agreement and the transactions contemplated thereby
USD	means US Dollars

List of Exhibits

Exhibit 3.2(a)	Ad hoc publication
Exhibit 3.2(b)	Form 8-K
Exhibit 3.2(c)	Joint press release
Exhibit 9.1(g)	Securities issued by SCM
Exhibit 9.1(h)	Participations held by SCM
Exhibit 9.2(g)	Securities issued by Bluehill
Exhibit 9.2(h)	Participations held by Bluehill

Preamble

WHEREAS

(A) SCM designs, develops and sells hardware, software and system solutions for access control applications of all kinds. As of the date hereof, SCM has issued and outstanding 25,134,985 shares of common stock with a par value of USD 0.001 each. SCM s shares are admitted for trading on the regulated market of the FSE (Prime Standard) (ISIN US7840181033, ticker symbol SMY) and on the NASDAQ (ticker symbol SCMM).

(B) Bluehill focuses its business activities on the use and development of radio frequency identification (RFID) and other automated identification and access control technologies. Bluehill serves its customers in diverse global markets spanning across the entire RFID and identification value chain. As of the date hereof, Bluehill has a registered share capital of CHF 32,023,797 and issued and outstanding 32,023,797 shares of common stock with a par value of CHF 1.00 each which are traded on the Open Market *(Freiverkehr)* at the FSE (ISIN CH0031958629, ticker symbol BUQ), 173.768 of which are held as treasury shares on the Signing Date (**Bluehill Shares**).

(C) The board of directors of SCM (**SCM Board**) and the board of directors *(Verwaltungsrat)* of Bluehill (**Bluehill Board**), after detailed considerations and negotiations as well as completion of a satisfactory due diligence of the respective other Party and its Subsidiaries, believe that a combination of the businesses of the Party Groups (**Combination**) is in the best interest of both Parties and their respective shareholders.

(D) The Parties have jointly considered various transaction structures to effect the Combination and have mutually agreed that the most desirable transaction structure, taking into account the interests of both Parties as well as of their respective shareholders, is a public share-for-share offer by SCM to Bluehill s shareholders (including any amendments, e.g. prolongations of the Offer period or waivers of conditions, **Offer**).

(E) Shareholders of Bluehill who accept the Offer will transfer their Bluehill Shares to SCM as a contribution in kind in exchange for new shares in SCM (**New Shares**).

(F) SCM intends to acquire all shares in Bluehill by the Offer, but in any event at least 75% of the Bluehill Shares.

(G) Both Parties are determined to carry out the Transaction and wish to enter into this Agreement which, in particular, sets forth on the one hand Bluehill s involvement in the Transaction and the support of the Offer by the Bluehill Board in accordance with applicable law, and on the other hand the agreement between the Parties as to the principle terms and their mutual understanding with respect to the realisation of the Transaction, the Transaction structure and the future mutual board representation in each of the Parties after the Closing.

NOW, THEREFORE, THE PARTIES HEREBY AGREE AS FOLLOWS:

1. Business rationale of the Transaction

Following numerous intensive discussions which have taken place between Bluehill and SCM, both Parties have come to the conclusion and agree that it would be in their and their respective shareholders best interest to execute the Transaction.

2. Implementation of the Transaction

2.1 The Transaction shall be achieved through the following main steps in the following chronological order:

Step 1 Signing of this Agreement by the Parties

Step 2 Announcement of the signing of this Agreement and the launch of the Offer in the near future

Step 3 Preparation of Offer Document, including the German Prospectus, and of Registration Statement, including the Proxy Statement for a special stockholders meeting of Henry in order to approve the Offer and the issuance of the New Shares

Step 4 Filing of Registration Statement, and any necessary amendments thereto, review of the Registration Statement by the Securities and Exchange Commission (**SEC**) and declaration of the Registration Statement s effectiveness by the SEC

Step 5 Review of German Prospectus by the German Federal Financial Supervisory Authority (**BaFin**)

Step 6 Mailing of Proxy Statement to SCM s stockholders

Step 7 Publication of Offer Document including German Prospectus

Step 8 Special stockholders meeting of SCM

Step 9 Closing of the Offer by exchange of Bluehill Shares against New Shares, listing of New Shares at NASDAQ and FSE and delivery of New Shares

2.2 SCM shall, subject to and in accordance with the applicable laws and the terms and conditions of this Agreement, without undue delay *(unverzüglich)* after the Signing Date

(a) prepare a registration statement on Form S-4 (**Registration Statement**), which contains a proxy statement in accordance with the United States Securities Exchange Act of 1934 to be distributed to SCM s stockholders (**Proxy Statement**),

(b) prepare a prospectus which satisfies the requirements of the German Securities Prospectus Act *(Wertpapierprospektgesetz)* (**German Prospectus**),

(c) prepare an offer document containing the Offer, the German Prospectus as well as any additional information required and being addressed to all the shareholders of Bluehill (**Offer Document),**

(d) provide to Bluehill, but not for the benefit of third parties, in respect of the German Prospectus, the Offer Document, the Registration Statement and the Proxy Statement, a certificate signed by the SCM CEO on behalf of SCM stating that

(i) the information provided by or on behalf of SCM for inclusion therein does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements in such information, in light of the circumstances in which they are made, not misleading in any material respect,

(ii) all expressions of opinion, intention or expectation provided by or on behalf of SCM for inclusion therein are truly and honestly held and made on reasonable grounds after due consideration and enquiry, and

(iii) all matters known to SCM which should be taken into account by the SEC and/or BaFin in the course of the review of the German Prospectus and the Proxy Statement have been provided by or on behalf of SCM to the SEC and/or BaFin,

(e) file the Registration Statement with the SEC for review,

(f) file the German Prospectus with the BaFin for review,

(g) subject to the complete satisfaction of Bluehill s covenants set forth in sections 11.5 and 11.6 of this Agreement, mail the Proxy Statement to SCM s stockholders after the SEC has declared it effective and after the BaFin has approved the German Prospectus,

(h) subject to the complete satisfaction of Bluehill s covenants set forth in sections 11.5 and 11.6 of this Agreement, publish the Offer Document (including the German Prospectus) after the SEC has declared the Proxy Statement effective and after the BaFin has approved the German Prospectus,

(i) hold a special stockholders meeting in order to have SCM s stockholders approve the Offer and the issuance of the New Shares to those shareholders of Bluehill who accept the Offer,

(j) apply for and use commercially reasonable efforts to obtain approval for the listing of the New Shares on NASDAQ and FSE,

(k) close the Offer by exchanging the tendered Bluehill Shares against the Share Consideration, and

(l) hold a meeting of its board of directors to appoint (i) the Bluehill CEO as executive chairman of the SCM Board and (ii) two additional members of the Bluehill Board, as designated by the Bluehill CEO, as members of the SCM Board, in each case to be effective at the Closing.

2.3 Bluehill shall, subject to and in accordance with the applicable laws and the terms and conditions of this Agreement, without undue delay *(unverzüglich)* after the Signing Date

(a) provide such assistance and information (financial or other) relating to Bluehill and its Subsidiaries as SCM may reasonably require in order to comply with its obligations set forth in section 2.2 to prepare, file and publish the German Prospectus, the Offer Document, the Registration Statement and the Proxy Statement in accordance with the applicable laws,

(b) obtain the consent of the Bluehill Auditor to the inclusion in the Registration Statement, Proxy Statement and the German Prospectus of (i) Bluehill s audited annual financial statements for all fiscal years since its incorporation and (ii) all financial information as described in lit. (a) above to the extent it was reviewed by the Bluehill Auditor, and

(c) provide to SCM, but not for the benefit of third parties, in respect of the German Prospectus, the Offer Document, the Registration Statement and the Proxy Statement, a certificate signed by the Bluehill CEO on behalf of Bluehill stating that

(i) the information provided by or on behalf of Bluehill for inclusion therein does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements in such information, in light of the circumstances in which they are made, not misleading in any material respect,

(ii) all expressions of opinion, intention or expectation provided by or on behalf of Bluehill for inclusion therein are truly and honestly held and made on reasonable grounds after due consideration and enquiry, and

(iii) all matters known to Bluehill which should be taken into account by the SEC and/or BaFin in the course of the review of the German Prospectus and the Proxy Statement have been provided by or on behalf of Bluehill to SCM.

2.4 Throughout the execution of the Transaction and notwithstanding sections 2.2 to 2.3, the Parties undertake vis-à-vis each other to use commercially reasonable efforts (within their respective control) to take or cause to be taken all appropriate measures, to enter into all legal transactions, to adopt all resolutions and to hold or prepare all meetings that may be required or expedient to implement the Transaction in accordance with this Agreement. In this context, the Parties shall inform each other on an ongoing basis on the status of their implementation steps and consult with each other in order to agree on the details of the required legal transactions, legal instruments *(Rechtsakte),* acts similar to legal transactions *(rechtsgeschäftsähnIiche Handlungen)* and factual actions *(tatsächliche Handlungen),* unless this conflicts with any applicable law or the rules of any regulatory body or results in a waiver of the attorney-client privilege. In particular, the Parties undertake to provide each other with a reasonable opportunity to review and comment upon any material legal documents with respect to each of the steps of the Transaction.

3. Obligation to launch the Offer; publication of launch

3.1 In order to implement the Transaction and subject to and in accordance with the applicable laws and the terms and conditions of this Agreement, SCM shall launch the Offer by publishing the Offer Document in which it offers to purchase all Bluehill Shares from Bluehill s shareholders in exchange for the Share Consideration. The Offer period shall last at least six weeks and no longer than twelve weeks. In the event of a Superior Offer, the Offer period may be extended by SCM so that it is as long as the offer period of the Superior Offer, even if this results in an Offer period longer than twelve weeks. In any event, the Offer period can be prolonged with the consent of Bluehill.

3.2 Immediately after the Signing Date,

(a) SCM and Bluehill shall publish the signing of this Agreement, their decision to execute the Transaction and SCM s decision to launch the Offer in the near future in accordance with German applicable law and German stock exchange regulations and requirements as set forth in Exhibit 3.2 (a),

(b) SCM shall publish the signing of this Agreement, the decision of the Parties to execute the Transaction and SCM s decision to launch the Offer in the near future in accordance with the requirements of Form 8-K used for current reports under section 13 or 15(d) of the United States Securities Exchange Act of 1934 as set forth in Exhibit 3.2 (b), and

(c) SCM and Bluehill shall publish a joint press release as set forth in Exhibit 3.2 (c).

3.3 SCM shall not be obligated to launch the Offer if a Termination Event occurs.

4. Share Exchange Ratio; Share Consideration

4.1 The Share Exchange Ratio is based on a valuation of Bluehill and of SCM performed by the Parties. Under the assumption that all Bluehill Shares are tendered during the course of the Offer and all holders of the Bluehill Shares receive the Share Consideration, the present shareholders of SCM will post Closing hold 60% of the shares in SCM and the present holders of Bluehill Shares will post Closing hold 40% of the shares in SCM.

4.2 The shareholders of Bluehill who tender their Bluehill Shares during the course of the Offer shall receive 0.52 (in words: zero point five two) New Shares for each Bluehill Share being tendered (such share exchange ratio **Share Exchange Ratio** and such New Shares **Share Consideration**). No adjustment of such share exchange ratio shall be made.

4.3 No fractions of New Shares will be issued. The Share Consideration received by any shareholder of Bluehill will be rounded down to an integer number of New Shares. In lieu of fractional shares, shareholders of Bluehill who have tendered Bluehill Shares will receive adequate compensation.

5. Offer Document

SCM shall draft the Offer Document in accordance with this Agreement, shall provide Bluehill with a draft of the Offer Document prior to the publication thereof and shall provide Bluehill with a reasonable opportunity to review the draft and provide comments thereon. The Parties acknowledge that SCM is free to take into account or not to take into account the comments made by Bluehill, if any.

6. Offer Conditions

6.1 The Offer shall be subject to the following conditions precedent:

(a) at least 75% of all Bluehill Shares are tendered in accordance with the terms of the Offer by the shareholders of Bluehill,

(b) approval of the Offer and the issuance of the New Shares by the stockholders of SCM in accordance with applicable law at SCM s special stockholders meeting,

(c) approval for the listing of the New Shares on NASDAQ, and

(d) absence of the occurrence of an event that has or would have a material adverse effect on either Party Group

(collectively **Offer Conditions**).

6.2 With the exception of the Offer Conditions set out in section 6.1 (b) and (c), SCM may entirely or partially waive any of the Offer Conditions at its sole discretion until the end of the working day prior to the expiry of the Offer.

6.3 The Parties agree to use their respective commercially reasonable efforts to ensure that the Offer Conditions set out in section 6.1 (a), (b) and (c) are satisfied as soon as reasonably practicable and in any event upon expiry of the Offer.

6.4 The Parties agree to use their respective commercially reasonable efforts to ensure that the approval for the listing of the New Shares on FSE is obtained as soon as reasonably practicable after Closing.

7. Recommendation of the Offer by Bluehill

7.1 As far as legally permissible under applicable law, until the earlier of the Closing Date or the termination of this Agreement, Bluehill will not, and will procure that its Subsidiaries do not, take any actions which could prevent the success of the Transaction.

7.2 Bluehill shall, to the extent legally permissible under applicable law, (i) use all commercially reasonable efforts to solicit its shareholders to tender their Bluehill Shares to SCM, (ii) cooperate with SCM in order to ensure that the Offer is successful and (iii) authorize SCM to include in the German Prospectus, the Offer Document, the Registration Statement and the Proxy Statement and publish after the announcement of the Offer on its website, in the Swiss Official Gazette of Commerce *(Schweizerisches Handelsamtsblatt)*, in the German Electronic Federal Gazette *(Elektronischer Bundesanzeiger)* a recommendation of the Offer, the wording of which shall be agreed upon by the Parties, stating that

(a) the Bluehill Board and management believe that the Transaction is in the best interest of Bluehill and its shareholders, and

(b) the Bluehill Board supports the Transaction and recommends to Bluehill s shareholders to accept the Offer and to tender their Bluehill Shares to SCM

(**Bluehill Recommendation**).

7.3 Bluehill shall, to the extent legally permissible, confirm the Bluehill Recommendation in any subsequent public statement made until the expiry of the Offer.

7.4 In the event that a third party launches a competing tender offer for the Bluehill Shares, Bluehill shall not withdraw or qualify the Bluehill Recommendation or recommend such competing tender offer, unless the Bluehill Board, acting reasonably and in good faith, determines in reliance on outside legal counsel and independent financial advice that such competing tender offer is materially more favourable to Bluehill and its shareholders than the Offer, taking into account, without limitation, all facts and circumstances in relation to the Transaction on the one hand and all terms and conditions of the competing tender offer, including its conditionality, the likelihood of its completion and the likely timing of the transaction, on the other hand. Bluehill shall inform SCM without undue delay (un-verzüglich) if it has determined that a competing tender offer is materially more favourable to Bluehill and its shareholders than the Offer and withdraws the Bluehill Recommendation. Such materially more favourable competing tender offer is, after the determination of the Bluehill Board (referred to in the first sentence of this section 7.4) and the information of SCM by Bluehill (referred to in the second sentence of this section 7.4) referred herein as a **Superior Offer** .

7.5 Bluehill s obligations set forth in this section are subject to

(a) the Offer having been launched in accordance with this Agreement,

(b) no Superior Offer having been launched by any third party,

(c) no circumstances existing that, in the opinion of the Bluehill Board acting in good faith, would cause the members of the Bluehill Board to violate their fiduciary duties under any applicable law by supporting and recommending the Transaction,

(d) the SCM Recommendation not being withdrawn, qualified or adversely modified, and

(e) no termination of this Agreement having occurred.

8. Approval by SCM s stockholders; recommendation by SCM

8.1 SCM shall convene a special stockholders meeting which resolves upon the approval of the Offer and the issuance of the New Shares in accordance with applicable law. Subject to its fiduciary duties under applicable law, the SCM Board shall recommend to SCM s stockholders to approve the Offer as well as the issuance of the New Shares. SCM will use its commercially reasonable efforts to cause the stockholders resolution to be passed before the expiry of the Offer.

8.2 To the extent legally permissible under applicable law, SCM shall cause the Offer Document and the Proxy Statement to contain a statement by the SCM Board that it believes that the Transaction, including the issuance of the New Shares, is in the best interest of SCM and its stockholders (**SCM Recommendation**).

8.3 SCM shall, to the extent legally permissible, confirm the SCM Recommendation in any subsequent public statement made until the expiry of the Offer.

8.4 SCM s obligations set forth in this section are subject to

(a) no Superior Offer having been launched by any third party,

(b) no circumstances existing that, in the opinion of the SCM Board acting in good faith, would cause the members of the SCM Board to violate their fiduciary duties under any applicable law by supporting and recommending the Transaction,

(c) the Bluehill Recommendation not being withdrawn, qualified or adversely modified, and

(d) no termination of this Agreement having occurred.

9. Representations and warranties

9.1 SCM represents and warrants to Bluehill as of the Signing Date to be reaffirmed at the Closing in a certificate signed by the SCM CEO on behalf of SCM that

(a) SCM and its Subsidiaries are duly organized and validly existing under applicable law and SCM has the requisite corporate power and authority to enter into and perform this Agreement,

(b) neither SCM nor any of its Subsidiaries is in a state of Insolvency and no Insolvency, bankruptcy, receivership or liquidation proceedings have been applied for regarding SCM or any of its Subsidiaries and, to SCM s Best Knowledge, no such proceedings have been threatened, nor do circumstances exist which would require or facilitate the initiation of such proceedings,

(c) SCM has provided Jupiter access to all information (financial or other) reasonably requested by Jupiter with respect to SCM and its Subsidiaries to prepare its fairness opinion, and, to SCM s Best Knowledge, such information provided by or on behalf of SCM for inclusion therein does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements in such information, in light of the circumstances in which they are made, not misleading in any material respect,

(d) SCM has provided Bluehill access to all information reasonably requested by Bluehill to conduct its due diligence of SCM and its Subsidiaries, and, to SCM s Best Knowledge, such information provided by or on behalf of SCM does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements in such information, in light of the circumstances in which they are made, not misleading in any material respect,

(e) this Agreement constitutes a binding obligation of SCM in accordance with its terms, subject to applicable bankruptcy laws and creditors rights,

(f) the execution and performance by SCM of this Agreement will not

(i) conflict with or violate its constitutional documents,

(ii) conflict with or violate any order, judgement or decree of any court or governmental agency by which SCM is bound or

(iii) except for obtaining the approval of SCM s stockholders and any necessary regulatory approvals, require the consent of any other person,

(g) except as shown in Exhibit 9.1 (g), no shares, exchangeable or convertible securities, warrants or similar instruments have been issued by SCM or any of its Subsidiaries and are outstanding on the Signing Date, no stock or other options have been issued by SCM or any of its Subsidiaries and are outstanding on 17 September 2009, and no Earn Out Agreement, plan, agreement or arrangement to issue any shares, exchangeable or convertible securities, stock or other options, warrants or similar instruments has been adopted or entered into by SCM or its Subsidiaries on the Signing Date,

(h) Exhibit 9.1 (h) sets out all participations in Subsidiaries of SCM directly held by SCM (**SCM Direct Participations**), the percentage of the share capital of such Subsidiaries such participations represent, all participations in Subsidiaries of SCM indirectly held by SCM (**SCM Indirect Participations**) and the percentage of the share capital of such Subsidiaries such participations represent, and

(i) SCM holds sole title to the SCM Direct Participations and the SCM Direct Participations are clear and free from any encumbrances. The Subsidiaries of SCM set out in Exhibit 9.1 (h) hold sole title to the SCM Indirect Participations and the SCM Indirect Participations are clear and free from any encumbrances.

9.2 Bluehill represents and warrants to SCM as of the Signing Date to be reaffirmed at the Closing in a certificate signed by the Bluehill CEO on behalf of Bluehill that

(a) Bluehill and its Subsidiaries are duly incorporated and validly existing under applicable law and Bluehill has the requisite corporate power and authority to enter into and perform this Agreement,

(b) neither Bluehill nor any of its Subsidiaries is in a state of Insolvency and no Insolvency, bankruptcy, receivership or liquidation proceedings have been applied for regarding Bluehill or any of its Subsidiaries and, to Bluehill s Best Knowledge, no such proceedings have been threatened, nor do circumstances exist which would require or facilitate the initiation of such proceedings,

(c) Bluehill has provided Jupiter access to all information (financial or other) reasonably requested by Jupiter with respect to Bluehill and its Subsidiaries to prepare its fairness opinion, and, to Bluehill s Best Knowledge, such information provided by or on behalf of Bluehill for inclusion therein does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements in such information, in light of the circumstances in which they are made, not misleading in any material respect,

(d) Bluehill has provided SCM access to all information reasonably requested by SCM to conduct its due diligence of Bluehill and its Subsidiaries, and, to Bluehill s Best Knowledge, such information provided by or on behalf of Bluehill does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements in such information, in light of the circumstances in which they are made, not misleading in any material respect,

(e) this Agreement constitutes a binding obligation of Bluehill in accordance with its terms, subject to applicable bankruptcy laws and creditors rights,

(f) the execution and performance by Bluehill of this Agreement will not

(i) result in a breach of its constitutional documents,

(ii) conflict with or violate any order, judgement or decree of any court or governmental agency by which Bluehill is bound or

(iii) require the consent of any other person,

(g) except as shown in Exhibit 9.2 (g), no shares, exchangeable or convertible securities, stock or other options, warrants or similar instruments have been issued by Bluehill or any of its Subsidiaries and are outstanding on the Signing Date and no Earn Out Agreement, plan, agreement or arrangement to issue any shares, exchangeable or convertible securities, stock or other options, warrants or similar instruments has been adopted or entered into by Bluehill or its Subsidiaries on the Signing Date,

(h) Exhibit 9.2 (h) sets out all participations in Subsidiaries of Bluehill directly held by Bluehill **(Bluehill Direct Participations**), the percentage of the share capital of such Subsidiaries such participations represent, all participations in Subsidiaries of Bluehill indirectly held by Bluehill **(Bluehill Indirect Participations)** and the percentage of the share capital of such Subsidiaries such participations represent, and

(i) Bluehill holds sole title to the Bluehill Direct Participations and the Bluehill Direct Participations are clear and free from any encumbrances. The Subsidiaries of Bluehill set out in Exhibit 9.2 (h) hold sole title to the Bluehill Indirect Participations and the Bluehill Indirect Participations are clear and free from any encumbrances.

9.3 For the purpose of this Agreement, a Party has **Best Knowledge** of a fact whenever a Relevant Person is or should, after reasonable investigation, be aware (*kennen oder kennen müssen*) of such fact. For the purposes of this section 9.3, **Relevant Persons** are the members of the Bluehill Board and the SCM Board, as well as the executive directors of the respective Party s Subsidiaries.

9.4 Each Party acknowledges that it is not relying on and has not been induced to enter into this Agreement on the basis of any warranties, representations, covenants, undertakings, indemnities or other statements whatsoever other than the representations and warranties set out in this section 9. Except in the case of fraud or intentional misconduct, no Party shall have any right of action against the other arising out of or in connection with any pre-contractual statement except to the extent it is repeated in this Agreement or the Confidentiality Agreement. For the purpose of this clause, pre-contractual statement means any draft, agreement, undertaking, representation, warranty, promise, assurance or arrangement of any nature whatsoever relating to the subject matter of the Transaction made or given by any person at any time prior to the date of this Agreement.

10. Remedies

10.1 In the event of any breach or non-fulfillment of any of the representations and warranties set forth in section 9.1 and 9.2, respectively, **(Breach**) the Party in Breach shall be liable for putting the other Party into the same position that such Party would have been in, if the Breach had not occurred (restitution in kind *Naturalrestitution*) within one month upon written notice of such Breach.

10.2 If and to the extent that the Party in Breach fails to provide restitution in kind within the period set forth in section 10.1, the Party in Breach shall pay monetary damages to the other Party in such amount as would be necessary to effect the restitution in kind.

10.3 Any indemnification obligation of a Party for a Breach as set forth in sections 10.1 and 10.2 (**Indemnification**) shall be limited to an aggregate amount of USD 7,500,000 (in words: seven million five hundred thousand) and shall cease to exist once the Closing occurred.

10.4 Any Indemnification shall be time-barred upon expiration of a period of 18 (in words: eighteen) months following the termination of this Agreement.

10.5 Subject to section 17, the Indemnification and all claims resulting therefrom under this section 10 supersede and replace any statutory rights, representations and warranties or guaranties of a Party under applicable law, and the remedies provided for by this section 10 shall be the exclusive remedies available to the Parties for a Breach. Any claims resulting from statutory rights, representations and warranties or guaranties of a Party are herewith excluded to the extent permitted by law.

11. Covenants

11.1 Until the earlier of the Closing or the termination of this Agreement, the Parties shall and shall procure that their respective Subsidiaries

(a) conduct their respective businesses in the ordinary course consistent with past practice, except for the measures contemplated in this Agreement, and in a manner that would not reasonably be expected to have a material adverse effect on the respective Party Group,

(b) use all commercially reasonable efforts (i) to keep available the services of their current key officers and employees *(Führungskräfte)* and (ii) to preserve their relationships with customers, suppliers, distributors, consultants, and with other third parties with whom they have business relationships and/or business dealings,

(c) inform each other on a monthly basis on their respective financial situation by providing monthly financial reports to the other Party,

(d) inform each other without undue delay *(unverzüglich)* about extraordinary management measures *(Geschäftsführungsmaßnahmen)* and other extraordinary events in relation to their respective businesses, in particular any measures, events or transactions that are material for them, and

(e) inform each other without undue delay *(unverzüglich)* about any breach of this Agreement including, but not limited to, any Breach.

11.2 Unless (i) required by applicable law, (ii) provided in this Agreement or (iii) agreed by the other Party in advance in writing (the consent of such Party not to be unreasonably withheld or delayed), until the earlier of the Closing or the termination of this Agreement, the Parties shall not and shall procure that their respective Subsidiaries do not

(a) issue new shares, issue or repurchase stock options, participation rights *(Genussrechte)* or convertible securities, except for stock options under SCM s 2007 stock option plan and 328 shares under SCM s expired employee stock purchase plan,

(b) resolve or agree on any repricing or material change of the terms and conditions of any existing stock options, share based payment obligations, participation rights *(Genussrechte)* or convertible loans or convertible securities,

(c) amend their respective certificate of incorporation or articles of association except for such amendments that are contemplated by SCM s preliminary proxy statement filed with the SEC on 18 August 2009 or have been or will be resolved by a special general, stockholders or shareholders meeting of a Party or any of its Subsidiaries called after the Signing Date by minority shareholders of such Party or any of its Subsidiaries (it being agreed that, should such a shareholder meeting be called after the Signing Date, the SCM Board or the Bluehill Board or the board of a Subsidiary of SCM or Bluehill, as the case may be, will, subject to their fiduciary duties under applicable law, recommend not to adopt such amendment),

(d) distribute any dividends to its shareholders,

(e) conclude agreements (i) to merge its business, substantial parts thereof or Subsidiaries with third parties, (ii) to acquire by merging or consolidating with, or by purchasing a substantial portion of the assets of or equity in, or by any other manner, any business or business organization or conclude enterprise agreements (within the meaning of sections 291 et seq. of the German Stock Corporation Act *Aktiengesetz*) or similar agreements substantially effecting a Party Group s business or pass resolutions for the approval of such agreements,

(f) divest substantial parts of its or any of its Subsidiaries assets or otherwise dispose of them, except that Bluehill may sell its shares in SCM at fair market value,

(g) other than in the ordinary course of business guarantee, or otherwise become responsible for any obligations of any person,

(h) make any loans, advances or capital contributions to, or other investments in, any other person or enter into any agreements relating thereto which individually exceed an amount of USD 25,000.00 or collectively an amount of USD 250.000,00,

(i) engage in hiring any employees with an individual annual compensation in excess of USD 150,000 or making any changes to the terms of employment of such employees or the terms of contract of advisors, commercial agents or distributors, in particular changes leading to the termination of employment or relating to the rate of salaries, bonuses or other incentives payable, or paying or agreeing or promising to pay, conditionally or otherwise, any bonus, extra compensation, pension or severance pay,

(j) enter into any transaction or perform any act which would be reasonably expected to interfere or be inconsistent with the successful completion of the Transaction or adversely affects the respective Party s ability to fulfill its obligations under this Agreement or

(k) settle any shareholder lawsuits seeking to prevent the Transaction.

11.3 Without prior consent of SCM, Bluehill shall not enter into any Earn Out Agreement or adopt any plan, agreement or arrangement to issue any shares, exchangeable or convertible securities, stock or other options, warrants or similar instruments until the earlier of the Closing or the termination of this Agreement.

11.4 Bluehill shall not, save as required by law, make or publish any profit forecast or prospective earnings statement that would trigger a reporting requirement under US, Swiss or German law between the signing date and the expiry of the Offer.

11.5 Bluehill shall use all commercially reasonable efforts that, and adopt such resolutions and enter into such agreements with SCM and third parties as, may be required in order to accomplish that at the Closing the Call Option Agreement, the Earn Out Agreements entered into by Bluehill or any of its Subsidiaries and the Bluehill ESOP shall cease to represent a right to acquire shares in Bluehill and shall in the future represent a right to acquire shares in SCM. The conversion shall take place applying the Share Exchange Ratio and, if necessary, by rounding down to the next integer number of shares in SCM. The options granted by the Call Option Agreement and issued pursuant to the Bluehill ESOP shall have an exercise price per share in SCM (rounded up to the nearest whole cent) equal to the exercise price per share in Bluehill divided by the Share Exchange Ratio.

11.6 Bluehill shall, without undue delay after the Signing Date, take all such steps as reasonably requested by SCM or as may be necessary or required, if any, to comply in all material respects with all applicable laws in connection with the capital increase as of 17 December 2008 and to amend the capital increase documentation accordingly and have registered such amended capital increase documentation with the register of commerce of the Canton of St. Gallen no later than on 15 October 2009, unless the register of commerce of St. Gallen determines that such amendment was not necessary.

11.7 Bluehill shall use all commercially reasonable efforts to acquire legal title to all shares in ACiG Technology Brazil Ltda. as soon as possible after the Signing Date.

12. Listing of New Shares

SCM shall use its commercially reasonable efforts to cause the New Shares to be listed on the NASDAQ and the FSE at the Closing Date.

13. Exclusivity

13.1 Until the earlier of either the Closing or the termination of this Agreement, except as may be necessary for compliance with fiduciary obligations under applicable law,

(a) no Party shall commence or continue discussions or negotiations with any third party regarding a transaction or series of transactions which are identical or similar (with regard to the economic or legal consequences to the respective Party Group) to the Transaction or which would result in such third party controlling the respective Party,

(b) no Party nor any of its Subsidiaries, representatives, agents, officers, directors or employees shall, without the prior written consent of the other Party, directly or indirectly in any manner initiate, solicit or encourage discussions with, or furnish or cause to be furnished any information to any third party regarding

(i) any Iicense or other transfer of rights, except for such licenses or transfers of rights in the ordinary course of business to customers,

(ii) any equity or debt investment in a Party or any of its Subsidiaries or any possible sale of a Party or any of its Subsidiaries (no matter how structured), including without limitation by sale of all or any significant or controlling part of the shares or assets of such Party or any of its Subsidiaries or by any merger or other business combination involving a Party or any of its Subsidiaries or otherwise,

(c) neither Party nor any of its Subsidiaries shall initiate discussions with any third party regarding any license or other transfer of rights or other transaction which could reasonably be expected to have a material adverse effect on the Transaction without the prior written consent of the other Party.

13.2 Notwithstanding section 7.4, in the event that one of the Parties or any of its Subsidiaries is, following the Signing Date, contacted by a third party regarding a transaction as set forth in section 13.1, the respective Party shall, to the extent permissible by its statutory confidentiality obligations (excluding contractual confidentiality undertakings), inform the other Party without undue delay *(unverzüglich)* that it has received such proposal by a third party and provide the details of such proposal including the identity of the third party.

14. Post Closing restructuring

14.1 Following the Closing, the Combination shall be subject to a restructuring as set forth in this section in order to raise all synergies as jointly identified by the Bluehill Board and the SCM Board prior to the Signing Date.

14.2 Without the intention to interfere with the rights and powers of the corporate bodies of the Parties and their shareholders, the SCM Board and the Bluehill Board shall, to the extent legally permissible under applicable law, use their commercially reasonable efforts and take all steps that may be required to achieve the following restructuring measures in due course after the Closing Date:

(a) to establish a joint cash pooling or an economically equivalent or similar inter-company lending structure between the Parties and their Subsidiaries,

(b) to generate cost savings and process efficiencies by combining operating activities of the Party Groups (overhead, headcount, locations, function, systems, etc.), and

(c) to raise sales and product cost synergies.

15. Post Closing corporate governance

15.1 Following the Closing, the Combination shall be given an organisational and governance structure as set forth in this section which adequately reflects the Share Exchange Ratio.

15.2 Without the intention to interfere with the rights and powers of the corporate bodies of the Parties and their shareholders, SCM and Bluehill shall, to the extent legally permissible under applicable law, use their commercially reasonable efforts and take all steps within their control that may be required to achieve the following organisational and corporate governance structure:

(a) upon request of SCM, the appointment of two members of the SCM Board, including the SCM CEO, as members of the Bluehill Board, in due course after the Closing Date but at the latest in Bluehill s next ordinary general meeting and

(b) a change of the name of SCM in order to reflect the Combination in due course after the Closing Date.

15.3 Should SCM acquire 90% or more of the Bluehill Shares in the course of the Offer, it will consider a squeeze-out merger under Swiss law.

16. Merger control

The Parties have the common understanding that the Transaction does not trigger any merger notification or clearance requirements in Australia, Germany, India, the Netherlands, Switzerland the US or any other country where the Parties and their Subsidiaries do business.

17. Termination

17.1 This Agreement can be terminated without prejudice to any other rights

(a) by mutual written consent of SCM and Bluehill,

(b) by a Party if the other Party has materially breached any of its representations and warranties contained in, or obligations pursuant to this Agreement, including but not limited to a Breach of any of the representations and warranties set forth in section 9, and in each case such breach has not been cured within 14 days of receipt of written notice of such breach by the non-breaching Party,

(c) by a Party if a general or stockholders meeting of the other Party or any of its Subsidiaries has adopted a resolution which would materially adversely affect or impede the Transaction,

(d) by either Party for cause *(aus wichtigem Grund)*,

(e) by a Party if an event has occurred or occurs that has or would reasonably be expected to have a material adverse effect on the other Party Group,

(f) by either Party, if the Closing has not occurred on or before 30 April 2010,

(g) by either Party, if the Bluehill Board no longer supports the Offer because it has resolved to support a Superior Offer and SCM has not, within five Business Days upon receipt of a respective notice by Bluehill, improved the Offer in such a way that it would be unreasonable for the Bluehill Board to further support the Superior Offer,

(h) by SCM, if SCM is, prior to launching the Offer, approached by a third party regarding a takeover of SCM and the SCM Board, acting reasonably and in good faith, determines in reliance on outside legal counsel and independent financial advice that such takeover is materially more favourable to SCM and its shareholders than the Transaction and inconsistent with the Transaction, taking into account, without limitation, all facts and circumstances in relation to the Transaction on the one hand and all terms and conditions of the proposed takeover, including its conditionality, the likelihood of its completion and the likely timing of the takeover, on the other hand,

(each a **Termination Event**).

17.2 The notice of termination of the Party which is entitled to terminate this Agreement pursuant to section 17.1 must be received by the other Party within two weeks after the Party which is entitled to terminate this Agreement obtained knowledge of the Termination Event on which the termination is based.

17.3 If a termination of this Agreement results from a Termination Event pursuant to section 17.1 (b), (d), (e) or (f) that has been caused by a Party s or any of its Subsidiaries wilful *(vorsätzlich)* or grossly negligent *(grob fahrlässig)* misconduct, such Party shall pay to the other Party a lump sum break-up fee in the amount of USD 1,500,000 (in words: one million five hundred thousand). Section 10 remains unaffected.

17.4 If this Agreement is terminated by either Party pursuant to section 17.1 (g), Bluehill shall pay to SCM a lump sum break-up fee in the amount of USD 2,000,000 (in words: two million).

17.5 If this Agreement is terminated by SCM pursuant to section 17.1 (h), SCM shall pay to Bluehill a lump sum break-up fee in the amount of USD 2,000,000 (in words: two million).

17.6 If fewer than 50% of the Bluehill Shares plus one Bluehill Share are tendered during the course of the Offer, Bluehill shall pay to SCM a lump sum break-up fee in the amount of USD 1,500,000 (in words: one million five hundred thousand).

18. Confidentiality; communication

18.1 SCM and Bluehill acknowledge that they have entered into the Confidentiality Agreement. The Parties agree that such agreement remains in full force and effect and shall also cover all information obtained by SCM in the course of any investigation undertaken by SCM before entering into this Agreement.

18.2 Notwithstanding section 18.1 and subject to section 2.4, SCM may disclose the contents of this Agreement in the Form 8-K announcing the entry into this Agreement, the German Prospectus, the Offer Document and/or the Registration Statement and Proxy Statement, in any supplementary document thereto and in any other public announcements relating thereto to the extent required by law and Bluehill may disclose the contents of this Agreement in the Bluehill Recommendation and in any other public announcements relating to the Offer if required by law.

18.3 Neither SCM nor Bluehill or any of their Subsidiaries will issue any press release or otherwise issue any written public statements with respect to the Transaction contemplated by this Agreement other than set forth section 18.2 or in Exhibit 3.2 (c) without the prior consent of the respective other Party, not to be unreasonably withheld or delayed, except as may be required by applicable law or regulations or requirements of any of the stock exchange or regulatory authority. In particular, SCM is free to release publications according to the US securities laws.

19. Costs

Subject to sections 10 and 17.3 each of the Parties shall pay its own fees and expenses in connection with this Agreement and the Transaction.

20. Notices

All notices and other communications hereunder shall be in writing and shall be delivered personally, by overnight courier or via facsimile (with a confirmatory copy sent by overnight courier) to the Parties at the following addresses (or at such other address for a Party as shall be specified by like notice):

If to the SCM, to:

SCM Microsystems, Inc.
1900-B Carnegie Avenue
Santa Ana, CA 92705
USA

Attention: Mr. Felix Marx
Fax No.: +1 949 2507372

with copies, which shall not constitute notice, to

Lovells LLP
Karl-Scharnagl-Ring 5
80539 München
Germany

Attention: Prof. Dr. Wolfgang Büchner
Fax No.: +49 89 29012222

and to

Gibson, Dunn & Crutcher LLP
555 Mission Street, Suite 3000
San Francisco, CA 94105
USA

Attention: Mr. Michael L. Reed
Fax No.: +1 415 3748459

If to Bluehill, to:

Bluehill ID AG
Dufourstraße 121
9001 St. Gallen
Switzerland

Attention: Mr. Ayman S. Ashour
Fax No.: +41 44 7838040

with copies, which shall not constitute notice, to

Peller Law
Dreikönigsstraße 45
8002 Zurich
Switzerland

Attention: Mr. Stefan Peller
Fax No.: +41 43 8176220

and to

AFR Aigner Fischer Radlmayr
Mörikestraße 7
70178 Stuttgart
Germany

Attention: Dr. Roderich Fischer
Fax No.: +49 711 48 9990100

and to

McDermott Will & Emery
28 State Street
34th Floor
Boston, MA 02109-1775
USA

Attention: Mr. Byron S. Kalogerou
Fax No.: +1 617 5343800

21. Miscellaneous

21.1 This Agreement shall be governed by and construed in accordance with the laws of the Federal Republic of Germany, with the exception of the Vienna Sales Convention (CISG) and the German conflict of laws rules.

21.2 Any dispute between the Parties with respect to any matter contained in or arising from the performance of this Agreement shall not be decided by the ordinary courts, but exclusively be decided by the rules of arbitration of the International Chamber of Commerce (ICC) by one or more arbitrators appointed in accordance with such rules of conciliation and arbitration of this court, through proceedings conducted in the English language, which decisions shall be binding and non-appealable. The arbitration proceedings shall be held in Munich, Germany.

21.3 Neither this Agreement nor any of the rights, interests or obligations hereunder shall be assigned by any of the Parties hereto (whether by operation of law or otherwise) without the prior written consent of the other Party. SCM may however make such assignment to a wholly owned Subsidiary, provided that (i) SCM remains jointly and severally liable, and that (ii) SCM ensures that the respective rights, interests and obligations are retransferred to SCM or one of its wholly owned Subsidiaries if the assignee ceases to be a wholly owned Subsidiary.

21.4 This Agreement shall supersede all and any prior written or oral agreements or declarations concluded between the Parties in connection with the Offer and/or the Transaction contemplated by this Agreement, provided, however, that the Confidentiality Agreement continues to apply. This Agreement may not be amended, modified or supplemented in any manner, whether by course of conduct or otherwise, except by an instrument in writing specifically designated as an amendment hereto, signed on behalf of each of the Parties.

21.5 If any term or other provision of this Agreement is invalid, illegal or incapable of being enforced by any rule of law, or public policy, all other terms, conditions and provisions of this Agreement shall nevertheless remain in full force and effect so long as the economic and legal substance of the Transaction contemplated by this Agreement are not affected in any manner materially adverse to any Party Group. Upon determination that any term or other provision is invalid, illegal or incapable of being enforced, the Parties shall negotiate in good faith to modify this Agreement so that it reflects the original intent of the Parties in a mutually acceptable manner and the Transaction can be consummated substantially as originally contemplated.

21.6 Nothing in this Agreement, express or implied, is intended to or shall confer upon any person other than the Parties and their respective successors and permitted assigns any legal or equitable right, benefit or remedy of any nature under or by reason of this Agreement. The representations and warranties set forth in this Agreement are the product of negotiations among the Parties and are for the sole benefit of the Parties. Any inaccuracies in such representations and warranties are subject to waiver by the Parties in accordance with section 21.4 without notice or liability to any other person. In some instances, the representations and warranties set forth in this Agreement may represent an allocation among the Parties of risks associated with particular matters regardless of the knowledge of any of the Parties. Consequently, persons (other than the Parties) may not rely upon the representations and warranties set forth in this Agreement as characterizations of actual facts or circumstances as of the date of this Agreement or as of any other date.

21.7 Definitions used in the singular include the plural and definitions used in the plural include the singular.

SCM Microsystems, Inc.	Bluehill ID AG
/s/ Felix Marx	/s/ Ayman S. Ashour
Name: Felix Marx Title: Chief Executive Officer	Name: Ayman S. Ashour Title: Chief Executive Officer

Table of Contents

Amendment Agreement

REGARDING THE

BUSINESS COMBINATION AGREEMENT

between

SCM Microsystems, Inc., a corporation incorporated in Delaware, USA, 1900-B Carnegie Avenue, Santa Ana, CA 92705, USA

SCM

and

Bluehill ID AG, a stock corporation incorporated in Switzerland, Dufourstraße 121, 9001 St. Gallen, Switzerland

Bluehill

dated 20 September 2009

Preamble

WHEREAS, the Parties hereto entered into a Business Combination Agreement on 20 September 2009 (**Agreement**).

WHEREAS, section 3.1 of the Agreement reads as follows:

In order to implement the Transaction and subject to and in accordance with the applicable laws and the terms and conditions of this Agreement, SCM shall launch the Offer by publishing the Offer Document in which it offers to purchase all Bluehill Shares from Bluehill s shareholders in exchange for the Share Consideration. The Offer period shall last at least six weeks and no longer than twelve weeks. In the event of a Superior Offer, the Offer period may be extended by SCM so that it is as long as the offer period of the Superior Offer, even if this results in an Offer period longer than twelve weeks. In any event, the Offer period can be prolonged with the consent of Bluehill.

WHEREAS, section 11.6 of the Agreement reads as follows:

Bluehill shall without undue delay after the Signing Date, take all such steps as reasonably requested by SCM or as may be necessary or required, if any, to comply in all material respects with all applicable laws in connection with the capital increase as of 17 December 2008 and to amend the capital increase documentation accordingly and have registered such amended capital increase documentation with the register of commerce of the Canton of St. Gallen no later than on 15 October 2009, unless the register of commerce of St. Gallen determines that such amendment was not necessary.

The Parties intend to amend the foregoing provisions and, therefore, agree as follows:

1. In compliance with section 21.4, second sentence, of the Agreement section 3.1 of the Agreement shall be amended and read as follows:

In order to implement the Transaction and subject to and in accordance with the applicable laws and the terms and conditions of this Agreement, SCM shall launch the Offer by publishing the Offer Document in which it offers to purchase all Bluehill Shares from Bluehill s shareholders in exchange for the Share Consideration. The Offer period shall last at least four weeks and no longer than twelve weeks. In the event of a Superior Offer, the Offer period may be extended by SCM so that it is as long as the offer period of the Superior Offer, even if this results in an Offer period longer than twelve weeks. In any event, the Offer period can be shortened or prolonged with the consent of Bluehill.

2. In compliance with section 21.4, second sentence, of the Agreement section 11.6 of the Agreement shall be amended and read as follows:

Bluehill shall without undue delay after the Signing Date, take all such steps as reasonably requested by SCM or as may be necessary or required, if any, to comply in all material respects with all applicable laws in connection with the capital increase as of 17 December 2008 and to amend the capital increase documentation accordingly and have registered such amended capital increase documentation with the register of commerce of the Canton of St. Gallen no later than on 31 October 2009, unless the register of commerce of St. Gallen determines that such amendment was not necessary.

3. All other terms and conditions of the Agreement shall remain unchanged.

Date: 20th October 2009	Date: 20 October 2009
SCM Microsystems, Inc.	Bluehill ID AG
By:	By:
/s/ Felix Marx	/s/ Ayman S. Ashour
Name: Felix Marx	Name: Ayman S. Ashour
Title: Chief Executive Officer	Title: Chief Executive Officer

Annex B

Jupiter Capital Services GmbH
Theatinerstr. 42
80333 München

September 16, 2009

Jupiter Capital Services GmbH, Theatinerstr. 42, 80333 München

Board of Directors

SCM Microsystems, Inc.
1900-B Carnegie Avenue
Santa Ana, CA 92705, USA

Fairness Opinion

To the attention of the Board of Directors of SCM Microsystems, Inc.

Dear Sirs:

We understand that SCM Microsystems, Inc., a Delaware corporation (SCM), and Bluehill ID AG, a Swiss corporation (BID), propose to enter into a business combination agreement (Agreement) pursuant to which SCM will make a public share-for-share offer to BID shareholders (Offer). Shareholders of BID who accept the Offer will transfer their BID Shares to SCM as a contribution in kind in exchange for new shares in SCM (New Shares). SCM intends to acquire all shares in BID through the Offer, but in any event at least 75% of the issued BID Shares (Transaction).

Shareholders of BID who accept and tender their shares in the Offer are expected to receive 0.52 shares of SCM s common stock for every one share of BID (Transaction Consideration). You have requested our opinion as to the fairness (Opinion), from a financial point of view, of the Transaction Consideration to be paid by SCM as part of the Transaction to shareholders of BID.

Jupiter Capital Services GmbH (Jupiter), as part of its corporate finance business, is engaged in the valuation of companies in connection with mergers and acquisitions and other corporate transactions. In connection with our Opinion, we have:

1. reviewed various financial forecasts and other data provided to Jupiter by SCM relating to the business of SCM and financial forecasts and other data provided to Jupiter by BID relating to the business of BID;

2. reviewed certain internal financial projections of SCM and BID on a pro forma combined basis, furnished to us by SCM and BID;

3. reviewed certain publicly available research analyst reports for SCM and BID;

4. reviewed certain financial statements of SCM and BID, including the consolidated financial statements for recent years and certain other relevant financial and operating data of SCM and BID made available to us by SCM and BID;

5. reviewed certain other communications from SCM and BID to their respective stockholders;

6. held discussions with members of the senior management of SCM and BID with respect to the businesses and prospects of SCM and BID, respectively;

7. reviewed the pro-forma financial impact of the Transaction on SCM and BID based on assumptions relating to transaction expenses, cost savings and other relevant adjustments as determined by the senior management of SCM;

September 16, 2009

8. reviewed public information with respect to certain other publicly traded companies Jupiter deemed relevant in evaluating the business of BID;

9. reviewed the financial terms, to the extent publicly available, of certain other business combinations Jupiter deemed to be reasonably comparable to the Transaction;

10. reviewed historical unit prices and trading volumes of the common units of SCM and BID, respectively; and

11. conducted such other financial studies, analyses and investigations as Jupiter deemed appropriate.

In performing our review, we have relied upon the accuracy and completeness of all of the financial and other information that was available to us from public sources, that was provided to us by SCM and BID for their respective representatives or that was otherwise reviewed by us and have assumed such accuracy and completeness for purposes of rendering this Opinion. We have further relied on the assurances of senior management of SCM and BID that they are not aware of any facts or circumstances that would make any of such information inaccurate or misleading. We have not been asked to and have not undertaken an independent verification of any of such information and we do not assume any responsibility or liability for the accuracy or completeness thereof. We did not make an independent evaluation or appraisal of the specific assets or the liabilities of SCM or BID or of any of their subsidiaries, or the collectibility of any such assets, nor have we been furnished with any such evaluations or appraisals. We have also not met with SCM s or BID s independent accounting firms.

With respect to the internal earnings estimates for SCM and BID provided by senior management of SCM and BID, respectively, and used by Jupiter in its analyses, SCM s and BID s senior management confirmed to us that they reflected the best currently available estimates and judgments of the respective senior managements of the respective future financial performance of SCM and BID and we assumed that such performance would be achieved.

With respect to the projections of transaction expenses, purchase accounting adjustments and cost savings determined by the senior management of SCM and BID, the senior management of SCM and BID confirmed to us that they reflected the best currently available estimates and judgements and we assumed that such performance would be achieved.

We express no opinion as to such financial projections or the assumptions on which they are based. We have also assumed that there has been no material change in SCM s and BID s assets, financial conditions, results of operations, business or prospects since the date of the most recent financial statements made available to us.

We have assumed in all respects material to our analysis that SCM and BID will remain as going concerns for all periods relevant to our analyses, that all of the representations and warranties contained in the Agreement and all related agreements are true and correct, that each party to the agreements will perform all of the covenants required to be performed by such party under the agreements, that the conditions precedent in the agreements are not waived. Our Opinion did not address any legal, tax, regulatory or accounting matters, as to which we understood that SCM obtained such advice as it deemed necessary from qualified professionals.

With your consent, we have undertaken no independent analysis of any potential or actual litigation, regulatory action, possible unasserted claims or other contingent liabilities to which SCM or BID are or may be a party or are or may be subject, or of any governmental investigation of any possible unasserted claims or other contingent liabilities to which SCM or BID are or may be a party or are or may be subject.

In connection with our Opinion, we have assumed that the Transaction will be consummated in a timely fashion on the terms and subject to the conditions described in the Agreement, without waiver or modification of

September 16, 2009

any of the material terms or conditions precedent to the Transaction contained in the Agreement by any party thereto. We also have assumed that all necessary governmental and regulatory approvals and third-party consents will be obtained on terms and conditions that will not have a material adverse effect on SCM or BID. We have also assumed that the final Agreement will not differ materially from the draft of the Agreement reviewed by us.

Our Opinion is necessarily based on financial, economic, market and other conditions as in effect on, and the information made available to us as of, the date hereof. Events occurring after the date hereof could materially affect this Opinion. We have not undertaken to update, revise, reaffirm or withdraw this Opinion or otherwise comment upon events occurring after the date hereof. We express no opinion herein as to the price at which SCM s common stock may trade at any time.

Our parent company, Jupiter Capital Partners GmbH (JCP), has acted as financial advisor to the Board in connection with the Transaction and will receive a fee for its services, a significant portion of which is contingent upon consummation of the Transaction. Jupiter will receive a fee for its services upon delivery of this Opinion, which fee is not contingent upon consummation of the Transaction. In addition, SCM has agreed to reimburse us for certain expenses and indemnify us for certain liabilities arising out of the rendering of this Opinion. JCP has in the past provided corporate finance, financial advisory and other financial services to BID, for which JCP received compensation. Jupiter and JCP may also provide corporate finance, financial advisory and other financial services to SCM in the future, for which Jupiter and JCP may receive compensation.

This Opinion should not be construed as creating any fiduciary duty on our part to any party. This Opinion is not intended to be, and does not constitute, a recommendation to the Board of Directors of SCM, any security holder or any other person as to how to act or vote with respect to any matter relating to the Transaction. This Opinion, including the contents hereof, is solely intended for the benefit and use of SCM s Board of Directors in connection with its consideration of the Transaction and does not address the underlying business decision of SCM to engage in the Transaction, the relative merits of the Transaction as compared to any other alternative business strategies, that might exist for SCM or the effect of any other transaction in which SCM might engage. We did not recommend any specific consideration to the Board of Directors of SCM or any other person nor indicated that any given consideration constituted the only appropriate consideration for the Transaction.

Our Opinion is not to be quoted or referred to, in whole or in part, in a registration statement, prospectus, proxy statement or in any other document, nor shall this Opinion be used for any other purposes, without Jupiter s prior written consent. We have not been requested to opine as to, and this opinion does not express an opinion as to or otherwise address the fairness, financial or otherwise, of the amount or nature of any compensation to or consideration payable to or received by any officers, directors or employees of any party to the Transaction, any class of such persons or any other party, relative to the Transaction Consideration or otherwise. This Opinion has been approved by Jupiter s fairness opinion committee.

Based upon and subject to the foregoing, including the various assumptions and limitations set forth herein, it is our opinion that, as of the date hereof, the Transaction Consideration to be paid by SCM in the Transaction is fair from a financial point of view, to SCM.

Sincerely,

/s/ Jupiter Capital Services GmbH

Handelsregister/Commercial Register: Amtsgericht München/Local Court of Munich HRB 180955

Table of Contents

PART II

INFORMATION NOT REQUIRED IN PROSPECTUS

INDEMNIFICATION OF DIRECTORS AND OFFICERS

SCM s Certificate of Incorporation, as amended and restated, limits the liability of directors to the maximum extent permitted by Delaware law. Section 102 of the Delaware General Corporation Law allows a corporation to include in its certificate of incorporation a provision that eliminates the personal liability of the directors of that corporation to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except where the director breached the duty of loyalty, failed to act in good faith, engaged in intentional misconduct or knowingly violated a law, authorized the payment of a dividend or approved a stock repurchase in violation of Delaware corporate law or obtained an improper personal benefit. SCM s charter documents provide that SCM shall indemnify its officers, directors and agents to the fullest extent permitted by law, including those circumstances where indemnification would otherwise be discretionary. SCM believes that indemnification under its charter documents covers at least negligence and gross negligence on the part of indemnified parties. SCM has entered into indemnification agreements with each of its directors and officers, which may, in some cases, be broader than the specific indemnification provisions contained in the Delaware General Corporation Law. The indemnification agreements may require SCM, among other things, to indemnify each director and officer against certain liabilities that may arise by reason of their status or service as directors or officers (other than liabilities arising from willful misconduct of a culpable nature) and to advance such persons expenses incurred as a result of any proceeding against him or her as to which such person could be indemnified.

Section 145 of the Delaware General Corporation Law authorizes a court to award, or a corporation s board of directors to grant, indemnification to directors and officers in terms sufficiently broad to permit such indemnification under certain circumstances for liabilities (including reimbursement for expenses incurred) arising under the Securities Act. Article VII of SCM s Bylaws provides for indemnification of its directors, officers, employees or agents to the maximum extent permitted under the Delaware General Corporation Law. SCM has entered into indemnification agreements with its officers and directors, which are intended to provide SCM s officers and directors with indemnification to the maximum extent permitted under the Delaware General Corporation Law.

At present, there is no pending litigation or proceeding involving a director, officer, employee or other agent of SCM in which indemnification is being sought, nor is SCM aware of any threatened litigation that may result in a claim for indemnification by any director, officer, employee or other agent of SCM.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers or persons controlling the registrant pursuant to the foregoing provisions, the registrant has been informed that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable.

Table of Contents

UNDERTAKINGS

The undersigned Registrant hereby undertakes:

(a) That prior to any public reoffering of the securities registered hereunder through use of a prospectus which is a part of this Registration Statement, by any person or party who is deemed to be an underwriter within the meaning of Rule 145(c), the issuer undertakes that such reoffering prospectus will contain the information called for by the applicable registration form with respect to reofferings by persons who may be deemed underwriters, in addition to the information called for by the other Items of the applicable form.

(b) That every prospectus (i) that is filed pursuant to paragraph (a) immediately preceding, or (ii) that purports to meet the requirements of section 10(a)(3) of the Act and is used in connection with an offering of securities subject to Rule 415, will be filed as a part of an amendment to the Registration Statement and will not be used until such amendment is effective, and that, for purposes of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(c) To respond to requests for information that is incorporated by reference into the prospectus pursuant to Items 4, 10(b), 11, or 13 of this Form, within one business day of receipt of such request, and to send the incorporated documents by first class mail or other equally prompt means. This includes information contained in documents filed subsequent to the effective date of the Registration Statement through the date of responding to the request.

(d) To supply by means of a post-effective amendment all information concerning a transaction, and the company being acquired involved therein, that was not the subject of and included in the Registration Statement when it became effective.

Table of Contents

EXHIBITS

See Exhibit Index.

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Santa Ana, State of California, on this 21st day of October, 2009.

SCM MICROSYSTEMS, INC.

/s/ Martin Wimmer
Martin Wimmer
Vice President, Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

POWER OF ATTORNEY

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities and on the date indicated. Each of the directors and/or officers of the Registrant whose signature appears below hereby appoints Felix Marx and Martin Wimmer and each of them severally as his attorney-in-fact to sign his name and on his behalf, in any and all capacities stated below, and to file with the Securities and Exchange Commission any and all amendments, including post-effective amendments to this Registration Statement as appropriate, and generally to do all such things in their behalf in their capacities as officers and directors to enable the Registrant to comply with the provisions of the Securities Act of 1933, and all requirements of the Securities and Exchange Commission.

Signature	Title	Date
/s/ Felix Marx Felix Marx	Chief Executive Officer (Principal Executive Officer), and Director	October 21, 2009
/s/ Martin Wimmer Martin Wimmer	Vice President Corporate Finance and Interim Chief Financial Officer (Principal Financial and Accounting Officer)	October 21, 2009
/s/ Werner Karl Koepf Werner Karl Koepf	Chairman of the Board of Directors	October 19, 2009
/s/ Steven Humphreys Steven Humphreys	Director	October 21, 2009
/s/ Dr. Hans Liebler Dr. Hans Liebler	Director	October 21, 2009

/s/ Lawrence W. Midland	Executive Vice President, Director	October 21, 2009
Lawrence W. Midland		
/s/ Douglas Morgan	Director	October 21, 2009
Douglas Morgan		
/s/ Simon Turner	Director	October 21, 2009
Simon Turner		

INDEX TO EXHIBITS

Exhibit Number	Description of Document
2.1(30)	Business Combination Agreement between SCM Microsystems, Inc. and Bluehill ID AG, dated September 20, 2009.
3.1(1)	Fourth Amended and Restated Certificate of Incorporation.
3.2(5)	Amended and Restated Bylaws of Registrant.
3.3(6)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of SCM Microsystems, Inc..
4.1(1)	Form of Registrant s Common Stock Certificate.
4.2(6)	Preferred Stock Rights Agreement, dated as of November 8, 2002, between SCM Microsystems, Inc. and American Stock Transfer and Trust Company.
4.3(24)	First Amendment to Rights Agreement, dated as of December 10, 2008, between SCM Microsystems, Inc. and American Stock Transfer and Trust Company.
4.4(29)	Form of Warrant Certificate.
5.1	Form of Opinion of Gibson, Dunn & Crutcher LLP as to the validity of the shares being issued.
10.1(26)*	Form of Director and Officer Indemnification Agreement.
10.2(8)*	Amended 1997 Stock Plan.
10.3(1)*	1997 Employee Stock Purchase Plan.
10.4(1)*	1997 Director Option Plan.
10.5(1)*	1997 Stock Option Plan for French Employees.
10.6(1)*	1997 Employee Stock Purchase Plan for Non-U.S. Employees.
10.7(2)*	2000 Non-statutory Stock Option Plan.
10.8(2)*	Dazzle Multimedia, Inc. 1998 Stock Plan.
10.9(2)*	Dazzle Multimedia, Inc. 2000 Stock Option Plan.
10.10(3)	Sublease Agreement, dated December 14, 2000 between Microtech International and Golden Goose LLC.
10.11(1)*	Form of Employment Agreement between SCM Microsystems GmbH and Robert Schneider.
10.12(4)	Tenancy Agreement dated August 31, 2001 between SCM Microsystems GmbH and Claus Czaika.
10.13(25)	Addendum No. 1 to the Lease Agreement of August 31, 2001, dated February 4, 2004.
10.14(25)	Addendum No. 2 to the Lease Agreement of August 31, 2001, dated June 2, 2008.
10.15(11)	Shuttle Technology Group Unapproved Share Option Scheme.
10.16(12)*	Management by Objective (MBO) Bonus Program Guide.
10.17(13)*	Employment Agreement between SCM Microsystems and Stephan Rohaly dated March 14, 2006.
10.18(14)	Purchase Agreement between SCM Microsystems and Kudelski S.A..
10.19(15)*	Restrictive Covenant between Kudelski S.A. and Robert Schneider dated May 22, 2006.
10.20(15)*	Amended Employment Agreement between SCM Microsystems GmbH and Robert Schneider dated May 22, 2006.
10.21(15)*	Amended Employment Agreement between SCM Microsystems GmbH and Dr. Manfred Mueller dated June 8, 2006.
10.22(14)	Lease dated July 15, 2006 between SCM Microsystems and Rreef America Reit II Corp..
10.23(16)*	Supplementary Employment Agreement between SCM Microsystems GmbH and Stephan Rohaly dated December 12, 2006.

10.24(17)*	Resignation and Severance Agreement between Robert Schneider and SCM dated June 18, 2007.
10.25(17)*	Consulting Agreement between Robert Schneider and SCM dated June 18, 2007.
10.26(18)*	Employment Agreement between Felix Marx and SCM dated July 31, 2007.
10.27(19)*	2007 Stock Option Plan.
10.28(20)*	Employment Agreement between Sour Chhor and SCM GmbH dated January 21, 2008.

Exhibit Number	Description of Document
10.29(20)*	Side Letter to the Employment Agreement between Sour Chhor and SCM GmbH dated January 23, 2008.
10.30(21)*	Supplementary Employment Agreement between SCM Microsystems GmbH and Felix Marx dated July 30, 2008.
10.31(21)*	Supplementary Employment Agreement between SCM Microsystems GmbH and Stephan Rohaly dated July 30, 2008.
10.32(22)	Code of Conduct and Ethics revised October 2008.
10.33(23)	Agreement and Plan of Merger among SCM Microsystems, Inc., Deer Acquisition, Inc., Hart Acquisition LLC and Hirsch Electronics Corporation dated as of December 10, 2008.
10.34(25)	Resignation Agreement between Sour Chhor and SCM GmbH dated February 5, 2009.
10.35(27)	Settlement Agreement between SCM Microsystems, Inc., Felix Marx, Secure Keyboards, Ltd., Secure Networks, Ltd., each of the respective general partners of Secure Keyboards and Secure Networks, and Hirsch Electronics Corporation, dated April 8, 2009.
10.36(27)	Limited Guarantee between SCM Microsystems, Inc., Secure Keyboards, Ltd. and Secure Networks, Ltd., dated April 8, 2009.
10.37(28)	Amended and Restated 1994 Settlement Agreement, by and among Hirsch Electronics Corporation, Secure Keyboards, Ltd. and Secure Networks, Ltd., dated April 8, 2009.
10.38(28)	Employment Agreement of Lawrence W. Midland, dated December 10, 2008.
10.39(28)	Stockholder Agreement, dated December 10, 2008.
10.40(31)*	Termination Agreement between Stephan Rohaly and SCM Microsystems GmbH, dated September 30, 2009.
21.1	Subsidiaries of the Registrant.
23.1	Consent of Jupiter Capital Services GmbH.
23.2	Consent of Deloitte & Touche GmbH.
23.3	Consent of Squar, Milner, Peterson, Miranda & Williamson, LLP.
23.4	Consent of Gibson, Dunn & Crutcher LLP (included in Exhibit 5.1 hereto).
24.1	Power of Attorney (included on the signature page and filed herewith)
99.1	Opinion of Jupiter Capital Services GmbHs (incorporated by reference to *Annex B* to the proxy statement and prospectus included in this Registration Statement).
99.2	Consents of Director Nominees pursuant to Rule 438 of the Securities Act
99.3	Form of Proxy Card SCM Microsystems, Inc.

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

(2) Filed previously as an exhibit to SCM s Registration Statement on Form S-8 (See SEC File No. 333-51792).

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

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

(5) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended September 30, 2002 (see SEC File No. 000-22689).

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

(7) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003 (see SEC File No. 000-29440).

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

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

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

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

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

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

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

(15) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (see SEC File No. 000-29440).

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

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

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

(19) Filed previously as an exhibit to SCM s Definitive Proxy Statement filed with the SEC on October 2, 2007 (See SEC File No. 000-29440).

(20) Filed previously as an exhibit to SCM s Current Report on Form 8-K, dated January 24, 2008 (see SEC File No. 000-29440).

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

(22) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated October 28, 2008 (see SEC File No. 000-29440).

(23) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated December 11, 2008 (see SEC File No. 000-29440).

(24) Filed previously as an annex to SCM s Registration Statement on Form S-4 filed with the SEC on January 30, 2009 (see SEC File No. 333-157067).

(25) Filed previously as an exhibit to SCM s Annual Report on Form 10-K for the year ended December 31, 2008 (See SEC File No. 000-29440).

(26) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated March 25, 2009 (see SEC File No. 000-29440).

(27) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated April 9, 2009 (see SEC File No. 000-29440).

(28) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated May 4, 2009 (see SEC File No. 000-29440).

(29) Filed previously as an exhibit to SCM s Quarterly Report on Form 10-Q for the quarter ended March 31, 2009 (see SEC File No. 000-29440).

(30) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated September 21, 2009 (see SEC File No. 000-29440).

(31) Filed previously as an exhibit to SCM s Current Report on Form 8-K dated September 30, 2009 (see SEC File No. 000-29440).

* Denotes management compensatory arrangement.