IDENTIVE GROUP, INC.
Form 10-K
March 07, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2010

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

COMMISSION FILE NUMBER 0-29440

IDENTIVE GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

DELAWARE	**77-0444317**
(State or other jurisdiction of Incorporation or organization)	**(I.R.S. Employer Identification Number)**
1900-B Carnegie Avenue, Santa Ana, California	**92705**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s telephone number, including area code:

(949) 250-8888

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

None

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

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

(Title of Class)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

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

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

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

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

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

Based on the closing sale price of the Registrant s Common Stock on the NASDAQ National Market System on June 30, 2010, the last business day of the Registrant s most recently completed second fiscal quarter, the aggregate market value of Common Stock held by non-affiliates of the Registrant was $47,876,909.

At March 1, 2011, the registrant had outstanding 48,275,702 shares of Common Stock, including 618,400 shares held in treasury.

DOCUMENTS INCORPORATED BY REFERENCE

Designated portions of the Company s Proxy Statement and Notice of Annual Meeting to be filed within 120 days after the Registrant s fiscal year end of December 31, 2010 are incorporated by reference into Part II, Item 5 and Part III of this Report.

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For the Fiscal Year Ended December 31, 2010

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Statement Regarding Forward Looking Statements

This Annual Report on Form 10-K, including the documents incorporated by reference in this Annual Report, contains forward-looking statements *for purposes of the safe harbor provisions under* Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. For example, statements, other than statements of historical facts regarding our strategy, future operations and growth, financial position, projected results, estimated revenues or losses, projected costs, prospects, plans, market trends, competition and objectives of management constitute forward-looking statements. In some cases, you can identify forward-looking statements by terms such as will, believe, could, should, would, may, anticipate, intend, plan, estimate, expect, project or the negat other similar expressions. Although we believe that our expectations reflected in or suggested by the forward-looking statements that we make in this Annual Report on Form 10-K are reasonable, we cannot guarantee future results, performance or achievements. You should not place undue reliance on these forward-looking statements. All forward-looking statements speak only as of the date of this Annual Report on Form 10-K. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our expectations change, whether as a result of new information, future events or otherwise. We also caution you that such forward-looking statements are subject to risks, uncertainties and other factors, not all of which are known to us or within our control, and that actual events or results may differ materially from those indicated by these forward-looking statements. We disclose some of the factors that could cause our actual results to differ materially from our expectations in the Customers, Research and Development, Competition, Proprietary Information and Technology, Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations sections and elsewhere in this Annual Report on Form 10-K. These cautionary statements qualify all of the forward-looking statements included in this Annual Report on Form 10-K that are attributable to us or persons acting on our behalf.

PART I

ITEM 1. *BUSINESS*

Overview of the Company

Identive Group, Inc. (Identive, the Company, the group, we and us) is an international technology company focused on building the world s signature group in secure identification-based technologies. We are comprised of a group of businesses with deep industry expertise and well-known global brands in their individual markets, which provide leading-edge products and solutions in the areas of physical and logical access control, identity management and radio frequency identification (RFID) systems to governments, commercial and industrial enterprises, healthcare and consumers. Our goal is to build a lasting business of scale and technology to both enable and capitalize on the growth of the security and RFID industries. Our growth model is based on a combination of strong technology-driven organic growth from the businesses within the group and disciplined acquisitive expansion.

At the beginning of 2010, we acquired Bluehill ID AG (Bluehill ID), a Swiss industrial holding group focused on technologies within the high-growth RFID / contactless smart card technology and identity

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management markets. As a result of this business combination, we have adopted a new organizational structure, enhanced and broadened our management team, and changed the name of the Company from SCM Microsystems, Inc. to Identive Group, Inc, which reflects our focus on providing secure identification systems and solutions. Following the acquisition of Bluehill ID we also changed our stock trading symbols to reflect our new name. Our common stock is listed on the NASDAQ Global Market in the U.S. under the symbol INVE and the Frankfurt Stock Exchange in Germany under the symbol INV.

Through 2009 and prior to the business combination with Bluehill ID, we operated in two business segments, Security and Identity Solutions and Digital Media and Connectivity. Following our business combination with Bluehill ID, our Company s organizational structure has changed, and we now operate in the following two business segments: Identity Management Solutions & Services (ID Management) and Identification Products & Components (ID Products). Each business segment is comprised of two or more businesses that focus on specific markets and technologies.

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

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

Sales from our ID Management segment accounted for approximately 56% of our total revenue in 2010 and 42% of our total revenue in 2009. Sales from our ID Products segment accounted for approximately 44% of our total revenue in 2010, 58% of our total revenue in 2009 and 100% of our revenue in 2008. Additional information about our results for the last three years for these segments is provided in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K. See Note 15 of Notes to Consolidated Financial Statements in Item 8 below for further details about revenue and assets by region.

Each of the businesses within Identive conducts its own sales and marketing activities in the markets in which it competes, utilizing its own sales and marketing organization, and in most cases selling primarily through indirect sales channels that may include dealers, systems integrators, value added resellers, resellers or the Internet. Within our ID Management segment, the majority of sales in our Hirsch business are made through a dealer/systems integrator distribution channel. Businesses in our ID Products segment primarily sell to original equipment manufacturers (OEMs) that typically either bundle our products with their own solutions, or repackage our products for resale to their customers. Our OEM customers typically sell our ID Products solutions to government contractors, systems integrators, large enterprises and computer manufacturers, as well as to banks

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and other financial institutions. Additionally, we sell our digital media readers primarily to major brand computer and photo processing equipment manufacturers.

Our corporate headquarters are co-located with our Hirsch business headquarters in Santa Ana, California and our European operational headquarters are in Ismaning, Germany. We maintain facilities in Chennai, India for technology research and development and in Australia, Brazil, Canada, Europe, Hong Kong, Japan, Singapore and the U.S. for individual business operations and sales. The Company was founded in 1990 in Munich, Germany and incorporated in 1996 under the laws of the state of Delaware. Our corporate headquarters are located at 1900 Carnegie Avenue, Building B, Santa Ana, California 92705.

Recent Acquisitions

On November 19, 2010, we acquired FCI Smartag Pte. Ltd. (Smartag), a Singapore-based manufacturer of high frequency (HF) and ultra high frequency (UHF) radio frequency identification (RFID) inlays and inlay-based solutions and a subsidiary of FCI Asia Pte. Ltd., FCI SA and FCI Connectors Singapore Pte. Ltd. (collectively, FCI). The acquisition was pursuant to a Share Purchase Agreement dated October 29, 2010, under which we paid FCI approximately $3.6 million, consisting of a one-time payment at the close of the transaction of approximately $1.0 million and a debt note for approximately $2.6 million. The debt note carries an interest rate of 6% per year and is payable within 30 months from the closing date. Smartag s operating results have been included in our consolidated results since November 19, 2010. The amount of the debt note is subject to change upon finalization of the closing balance sheet between the company and FCI.

On April 14, 2010, we acquired RockWest Technology Group, a privately-held provider of identification and security solutions based in Denver, Colorado (RockWest), pursuant to the Share Purchase Agreement dated March 30, 2010 and amended on April 9, 2010, under which we issued an aggregate of 2.6 million shares of our common stock. RockWest s operating results have been included in our consolidated results since April 14, 2010. RockWest was integrated into the Company s Multicard business in September 2010 and changed its name to Multicard U.S.

On January 4, 2010, we acquired Bluehill ID, pursuant to the Business Combination Agreement dated as of September 20, 2009, as amended, under which we made an offer to the Bluehill ID shareholders to acquire all of the Bluehill ID shares and issued 0.52 new shares of Identive common stock for every one share of Bluehill ID tendered. A total of 29,422,714, or approximately 92% of Bluehill ID shares outstanding were tendered in the offer and exchanged for a total of 15,299,797 new shares of Identive common stock. Immediately following the close of the transaction, approximately 38% of the Company s outstanding shares were held by the former Bluehill ID shareholders. Businesses acquired as part of the business combination with Bluehill ID include ACiG Technology, Arygon, Multicard, Syscan ID and TagStar Systems. Bluehill ID s operating results have been included in our consolidated results since January 4, 2010.

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

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Businesses within the Group

Currently, Identive is comprised of the following businesses and brands:

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

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

Multicard. Multicard is a worldwide supplier of card solutions for secure identification programs, with in-house capabilities for credential issuance, personalization and fulfillment services for the consumer, government, education, healthcare and corporate markets. Multicard offers ID systems management and engineering services as well as full implementation and program management. Multicard is also a provider of enrollment, accreditation and program management solutions for government ID, emergency management and other commercial and corporate ID applications. Multicard operates in the U.S., Switzerland, Germany, the Netherlands and Australia, and serves various customer groups ranging from governments and municipalities, to commercial and industrial companies and non-governmental organizations. (www.multicard.com)

SCM Microsystems. SCM Microsystems is a provider of solutions for secure access, secure identity and secure exchange. SCM designs and manufactures a broad range of contact, contactless and mobile smart card reader and terminal technology, digital identity and transaction platforms that are utilized around the world to enable security and identification applications, transaction systems, eHealth- and eGovernment programs and physical access systems. Through its Arygon brand, SCM offers advanced RFID reader modules for physical and logical access, transit and event ticketing, payment, government ID, industrial, medical and NFC applications, as well as RFID cards, key fobs, wristbands, custom tags and NFC starter kits. SCM also offers a range of smart card-based security, productivity and time recording solutions for small and medium-size businesses under its retail CHIPDRIVE® brand. Additionally, SCM provides commercial digital media readers to the worldwide photo kiosk market. SCM serves its global customer base with headquarters in Germany and sales offices in the U.S., Tokyo, and Hong Kong as well as a research and development center in India**.** (www.scmmicro.com)

Smartag. Located in Singapore, Smartag is a leading producer of high frequency (HF) and ultra high frequency (UHF) RFID inlays and inlay-based solutions including labels and smart tags. Smartag s ability to utilize multiple antenna technologies and designs provides the business with significant versatility in customizing solutions for different applications, including asset tracking, ticketing transactions, and secure mobile payments. (www.smartag.sg)

Syscan ID. Syscan ID (formerly Syscan International) is a producer of RFID ISO wand readers, also known as electronic id readers (EID) for livestock and other animal applications. The business is centered on animal ID, traceability, country of origin labeling (COOL) and age verification, as well as on industrial applications where a rugged RFID handheld reader is needed. Syscan ID also develops and customizes RFID readers and printer kits, offering complete mobile identification tools in the agriculture and industrial sectors. Markets are keyed to wherever livestock traceability and industrial

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tracking management is needed, which includes Europe, North America, South America and Australia. (www.syscan.com)

TagStar Systems. TagStar Systems is an RFID transponder manufacturer based in Germany with significant know-how in the design and manufacture of RFID inlays, which are purchased by specialist companies for conversion into event or venue cards or tickets, such as ski tickets, football games or concerts, and for transport tickets and passes. TagStar Systems particular skill is to cost-effectively combine and connect integrated circuit chips from NXP, Infineon, and others, with antennas into an inlay that can withstand the physical and environmental stresses in the applications in which their products are used. (www.tagstar-systems.de)

Need for Identification Systems

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

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

Market for RFID-based Information Systems

The market for RFID technology grew from $4.9 billion in 2007 to approximately $5.6 billion in 2009 (IDTechEx & ABI Research). For calendar year 2010 it is expected to grow by 16% and reach $6.1 billion according to ABI Research in their RFID Annual Market Overview. ABI Research s longer term projections for the overall RFID market also remain positive with an estimated 11% compound annual growth rate (CAGR) through 2014, when the market is expected to approach $9.2 billion. A primary driver of RFID growth is the increase in programs being implemented by governments and companies to identify and control individuals and access. Government mandates are a significant driver of market growth, as they create the demand for effective and efficient ways to identify and track people, animals and goods. As organizations augment or expand their existing security systems, RFID technology also provides a convenient and cost effective way to extend authentication of users to multiple points in the systems, for example entry doors and PCs. Additionally, consumer-oriented entities are turning to RFID to facilitate and speed up payment, client identification and admission to a variety of events.

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

Payment and Banking. As RFID technology has become more standardized and found wider consumer acceptance, banks and other financial institutions have begun to use it in advanced applications. Compared to

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many other forms of existing technology, RFID offers higher data transmission capacity and speed, improved convenience and additional security features that make it ideal for use in sensitive applications, such as contactless payment systems. Various financial institutions have begun issuing RFID-based contactless payment cards which will eventually replace cards containing only the conventional magnetic stripe. For example, MasterCard (Paypass), Visa (Contactless Visa) and others already have contactless payment systems in place. Similar contactless cards are being used in closed payment systems to purchase fuel (e.g., Mobil Paypass) and on college campuses for use in cafeterias, book stores, libraries, sporting events, concerts, exercise gyms, and similar venues.

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

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

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

Mass Transit. In many areas of the world, contactless cards are used to pay fares and tolls in mass transit and highway systems have been the driving factor in consumer acceptance of contactless technology. Contactless cards have been introduced in many of the largest mass transit systems around the world, including the Sao Paolo transportation system, the Malaysian Road Toll System, the Singapore EZ Link, the Charlie Card in Boston, the Metro Card in Washington, DC and New York City, the Oyster card in London, and numerous others. Such cards reduce traffic congestion, improve efficiency and reduce the need for people to handle cash, thereby improving security. Many passengers find the cards more convenient to use than traditional tickets. In addition, such cards

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can be combined with contactless payment functions (for use in restaurants and convenience stores, for example) or loyalty systems, which further increases passenger convenience. Mass transit cards have historically accounted for the largest share of the contactless card market and have constituted the most practical and visible demonstration of the technology s potential.

Convergence Trends

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

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

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

Finally, the marriage of identification technologies with mobile communication is transforming the way that consumers use mobile phones and other handheld devices by enabling new applications for communication, social interaction, and electronic transactions. With smart device capabilities, mobile phones and other devices enable consumers to purchase goods and services electronically and conveniently, while ensuring security through individual authentication of the user. In effect, the mobile phone becomes an electronic wallet that can handle payment and other secure transactions. Integration of contactless payment technology such as Near Field Communication (NFC) into mobile phones is expected to further spur demand for contactless technology over the next several years. According to the research firm Gartner Group, the number of consumers using mobile payment services via mobile phones and other devices is expected to grow from 32.9 million users in 2008 to 103.9 million in 2011. In 2011 the majority of these smart phones are expected to include built-in support for contactless RFID technology. IMS Research further predicts that shipments of NFC-enabled devices will increase dramatically in the next five years, with the launch of a number of NFC-enabled smartphones in 2011 helping the market to gain traction. Also, IMS projects that the use of NFC-enabled phones for payment, access, mass transit and ticketing also will boost market development over the next few years.

The Identification System Value Chain

To supply the various applications in the marketplace for RFID-based identification systems, a value chain has developed that comprises many steps and is fairly complex. As with other technology offerings in developing

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markets, many small players have emerged to supply the different components of a system. The majority of contactless identification systems consist of three components: (i) a transponder which acts as a data carrier and may be in the form of a smart card, tag, key fob or label, (ii) a reader and (iii) a software system.

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

Transponders

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

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

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

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

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

System integrators. System integrators purchase printed and laminated cards from card manufacturers, printed and assembled ePassport booklets from secure printing houses and, in certain instances, white

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

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

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

Our Specific Opportunity: How We Address Opportunities in the Information System Value Chain

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

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

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Through our technology research and development center in Chennai, India and our group of businesses, we currently address initial coverage of several important areas of the RFID-based identification systems value chain:

Segment of the Value Chain	Our Coverage
Silicon chip components and wafers	*ACiG Technology* has a direct business partnership with NXP, the leading semiconductor manufacturer in RFID and NFC.
Antennae	*Smartag and TagStar* expertise in antenna design and material packaging in HF and UHF.
	Identive Technology Development Center in India expertise in antenna design in LF and HF for passports, readers, and desktop applications.
Inlay production	*ACiG Technology* supplier and value-added distributor of RFID and smart card ICs, inlays and other components. Sourcing partner for Bluehill ID providing other companies within the group with RFID components.
	Smartag and TagStar know-how in the design and manufacture of RFID inlays for cards used in ski applications, industrial and medical applications, event and transportation tickets and passes, secure mobile payments and custom applications.
Readers	*SCM Microsystems* leading supplier of smart card readers and components for PCs, networks, physical facilities and authentication programs. SCM-branded products include both contact and contactless smart card readers and terminals, USB tokens and ASICs. Arygon-branded products include advanced RFID reader modules for a range of applications. CHIPDRIVE-branded products include small office productivity packages.
	ACiG Technology supplier and value-added distributor of RFID reader modules.
	Syscan ID producer and supplier of RFID mobile wand readers (electronic ID readers) for livestock and industrial applications.
Card Personalization /Secure Printing Houses	*Multicard* (Australia, Switzerland) suppliers of multi-functional smart card solutions for secure identification programs. In-house capabilities for credential issuance, personalization and fulfillment services for the consumer, government and corporate markets. Provider of online enrollment services and portable biometric data capture equipment for enrollment of ePassport and other government and corporate ID applications.
ID System Software and Interfaces	*Multicard* (Germany, Netherlands, Australia) worldwide supplier of multi-functional smart card solutions for identification programs and for payment, stadiums, and ticketing/voucher/loyalty systems. A supplier of hardware and software for ID/key management, database management, archiving, transaction processing, and reporting.
	Multicard (U.S.) full-service identification and security provider that supplies photo-identification, credential issuance, emergency management solutions and electronic security systems to the education, government, gaming and healthcare markets.
	Hirsch leading provider of security and identity management systems that integrate access control, video surveillance, intrusion detection, building management and other network-based systems using a wide range of credentials, including digital certificates, smart cards, RFID cards, and biometrics.

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

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

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

Customers

In our Hirsch and SCM Microsystems businesses, the U.S. government is an important customer for us. A majority of our sales to U.S. government entities or programs are made through our indirect sales network, which assumes the direct contracting risk associated with government orders. Sales made by our business units directly to U.S. government entities are normally priced using published General Service Administration schedules and are not negotiated as individual contracts. As a result, we are not subject to any material risk of renegotiation or termination at the election of these government entities. Across all of our businesses, a significant part of our revenues also come from local governments, large enterprises, public utilities and other critical infrastructure, data centers and the healthcare, education, communications, finance, transportation and manufacturing markets. Prior to our merger with Hirsch, sales to a relatively small number of customers historically accounted for a significant percentage of the Company s total sales. Sales to our top ten customers accounted for approximately 24% of total revenue in 2010, 42% of total revenue in 2009 (which includes sales made by the Hirsch business in the last eight months of 2009), and 58% of total revenue in 2008. In 2010 and 2009, no customer accounted for more than 10% of the Company s total revenue. In 2008, Tx Systems, Inc. and Flextronics America, LLC (formerly Solectron) each accounted for more than 10% of the Company s total revenue. We believe that the greater diversity of our customer base following our business combination with Bluehill ID and our acquisition of RockWest and Smartag has offset our dependence on a limited number of customers in our SCM Microsystems and Hirsch business areas. However, the loss or reduction of orders from a significant customer, including losses or reductions due to manufacturing, reliability or other difficulties associated with our products, changes in customer buying patterns, or market, economic or competitive conditions in the digital information security business, could still impact our business and operating results.

Sales and Marketing

For the majority of our sales, we utilize a multi-tiered sales organization consisting of OEMs, distributors, dealers/system integrators, value-added resellers, resellers and the Internet. Across all our businesses, we sell both directly and indirectly and our sales staff solicits prospective channel partners and customers, provides technical advice and support with respect to our products and works closely with customers, distributors and OEMs. In a number of our businesses we utilize authorized dealers or resellers who in turn resell and install our products, and who are trained by the individual businesses. In support of our sales efforts, we participate in trade

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shows and conduct sales training courses, targeted marketing programs and advertising, and ongoing customer and third-party communications programs.

Seasonality

In our business overall, we may experience significant variations in demand for our products quarter to quarter. This is particularly true for our smart card readers and other products targeting citizen /national ID applications, a significant portion of which are currently sold for smart card-based ID programs run by various U.S., European and Asian governments. Sales of our smart card readers and chips for government programs are impacted by testing and compliance schedules of government bodies as well as roll-out schedules for application deployments, both of which contribute to variability in demand from quarter to quarter. Further, this business is typically subject to seasonality based on governmental budget cycles, with lowest sales in the first quarter and highest sales in the fourth quarter of each year. During 2010, semiconductor shortages have at times constricted our ability to fulfill demand from our customers in our SCM and TagStar businesses, and if semiconductor supply does not become stable, sales at SCM, TagStar or other Identive businesses could continue to be affected in future periods. Additionally, our dependence on a small number of customers in our ID Products segment may result in any given period in additional variability in our revenues. Further, in our U.S. Multicard business, demand is affected by local and state government cycles as well as educational calendars, and therefore is typically strongest in the summer months and weakest in the fourth quarter.

Backlog

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

Research and Development

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

We focus the bulk of our R&D activities on the development of products for new and emerging market opportunities. R&D expenses were approximately $4.7 million in 2010, $4.3 million in 2009 and $3.1 million in 2008. The majority of our R&D activities for smart card readers, ePassport readers and digital media reader products occurs in India; the majority of R&D activities for our Hirsch products occurs in California; the majority of R&D activities for inlays occur in Sauerlach, Germany and Singapore; and the majority of R&D activities for card and payment software systems occurs in Villingen, Germany and Rotterdam, the Netherlands. As a result of the acquisition of Bluehill ID, we added a second development center located in Chennai, India, which we consolidated into our existing development operations during 2010 in order to lower operating costs.

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Manufacturing and Sources of Supply

For the most part, we utilize the services of contract manufacturers in various countries around the world to manufacture our products and components. In general, each business within the group manages its own manufacturing activities. Our Hirsch products are manufactured primarily in California, using locally sourced components. Our SCM-branded smart card reader and digital media reader products and components are manufactured in Singapore and China and SCM is certified to the ISO 9001:2000 quality manufacturing standard. Products and components for SCM s Arygon-branded smart card readers and ePassport readers are manufactured in Germany and India. Our inlay products are manufactured and assembled by Smartag s internal manufacturing organization in Singapore using locally sourced components and by TagStar s internal manufacturing organization in Sauerlach, Germany, using components sourced both locally and in Asia.

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

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

On an ongoing basis, we analyze the need to add alternative sources for both our products and components. For example, we currently utilize the foundry services of external suppliers to produce our ASICs for smart cards readers and inlays, and we use chips and antenna components from third-party suppliers in our contactless smart card readers. Wherever possible, we have added additional sources of supply for components. However, a risk remains that we may be adversely impacted by an inadequate supply of components, price increases, late deliveries or poor component quality. In addition, some of the basic components used in our reader products, such as semiconductors, may at any time be in great demand. This could result in components not being available to us in a timely manner or at all, particularly if larger companies have ordered more significant volumes of those components, or in higher prices being charged for components.

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

Following our business combination with Bluehill ID, we have worked to expand the application of a global sourcing strategy that was originally implemented by ACiG Technology for the Bluehill ID companies to serve all the businesses within the group. We believe our global sourcing strategy will enable us to achieve economies of scale and uniform quality standards for our products, and to support gross margins.

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Competition

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

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

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

We also experience indirect competition from certain of our customers who currently offer alternative products or are expected to introduce competitive products in the future. We may in the future face competition from these and other parties that develop security and RFID products based upon approaches similar to or different from those employed by us. In addition, the market for security and RFID products may ultimately be dominated by approaches other than the approach marketed by us. We believe that the principal competitive factors affecting the market for our products include:

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

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

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Proprietary Technology and Intellectual Property

Our success depends significantly upon our proprietary technology. We currently rely on a combination of patent, copyright and trademark laws, trade secrets, confidentiality agreements and contractual provisions to protect our proprietary rights, which afford only limited protection. Additionally, our Hirsch business utilizes Intellectual Property Infringement Abatement Insurance to partially mitigate the risk of infringement of its primary patent. Although we often seek to protect our proprietary technology through patents, it is possible that no new patents will be issued, that our proprietary products or technologies are not patentable, and that any issued patent will fail to provide us with any competitive advantages.

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

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

We own approximately 30 patent families (designs, patents, utility models and exclusive licenses) comprising a total of 120 individual or regional filings, covering products, mechanical designs and ideas for our various businesses. None of our patents are material to our business. Additionally, we leverage our own ASIC designs for smart card interface in some of our reader devices.

Employees

As of December 31, 2010, we had 387 full-time employees. We are not subject to any collective bargaining agreements and, to our knowledge, none of our employees are currently represented by a labor union. To date, we have experienced no work stoppages and believe that our employee relations are generally good.

Foreign Operations; Properties

We operate globally, with corporate headquarters in Santa Ana, California and European operational headquarters in Ismaning, Germany. The Company and our individual businesses also maintain leased facilities in Australia, Brazil, Canada, Germany, Hong Kong, India, Italy, Japan, the Netherlands, Singapore, Switzerland and the U.S. We consider these properties as adequate for our business needs.

Legal Proceedings

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

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

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

Availability of SEC Filings

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

ITEM 1A. *RISK FACTORS*

Our business and results of operations are subject to numerous risks, uncertainties and other factors that you should be aware of, some of which are described below. The risks, uncertainties and other factors described in these risk factors are not the only ones facing our company. Additional risks, uncertainties and other factors not presently known to us or that we currently deem immaterial may also impair our business operations. Any of the risks, uncertainties and other factors could have a materially adverse effect on our business, financial condition, results of operations, cash flows or product market share and could cause the trading price of our common stock to decline substantially.

Risks of Market Dynamics

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

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

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

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

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majority of our outstanding trade receivables are not covered by collateral or credit insurance. We may not be able to monitor and limit our exposure to credit risk on our trade and non-trade receivables, and we may not be effective in limiting credit risk and avoiding losses.

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

Continuing disruption in the global financial markets as a result of ongoing global economic weakness or uncertainty may cause consumers, businesses and governments to defer purchases in response to tighter credit, decreased cash availability and low consumer confidence. Accordingly, demand for our products could fail to grow or could decrease and differ materially from our current expectations. In addition, some of our customers may require substantial financing in order to fund their operations and make purchases from us. The inability of these customers to obtain sufficient credit to finance purchases of our products and meet their payment obligations to us, or possible insolvencies of our customers, could result in decreased customer demand, an impaired ability for us to collect on outstanding accounts receivable, significant delays in accounts receivable payments, and significant write-offs of accounts receivable, each of which could adversely impact our financial results.

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

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

Our markets are highly competitive.

The markets for our products are competitive and characterized by rapidly changing technology. Additionally, the demand for higher security environments including rapid certified identity authentication has led to new standards driving the need for new technology solutions. We believe that the principal competitive factors affecting the markets for our products and solutions include:

- the extent to which products and systems must support evolving industry standards and provide interoperability;
- the extent to which standards are widely adopted and product and system interoperability is required within industry segments;
- the extent to which products are differentiated based on technical features, quality and reliability, ease of use, strength of distribution channels and price;
- the ability of suppliers to quickly develop new products and integrated solutions to satisfy new market and customer requirements;
- the total cost of ownership including installation, maintenance and expansion capability of systems; and
- the ability to productize custom solutions for common customer requests.

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

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We also experience indirect competition from certain of our customers who currently offer alternative products or solutions or are expected to introduce competitive offerings in the future. For example, in our SCM Microsystems business, we sell our products to OEMs who incorporate our products into their offerings or who resell our products in order to provide a more complete solution to their customers. If our OEM customers develop their own products to replace ours, this would result in a loss of sales to those customers, as well as increased competition for our products in the marketplace. In addition, these OEM customers could cancel outstanding orders for our products, which could cause us to write down inventory already designated for those customers. In our Hirsch business, many of our dealer channel partners act as system integrators, providing installation and service, and therefore carry competitive lines of products and systems. This is a common practice within the industry as the integrators need access to multiple lines in order to support all potential service and user requirements. Depending on the technical competence of their sales forces, comfort level of their technical staff with our systems and price pressure from customers, these integrators may choose to offer a competitive system. There is also business pressure to provide some level of sales to all vendors to maintain access to a range of products and systems.

We may, in the future, face competition from these and other parties that develop secure identification products based upon approaches similar to or different from those employed by us. In addition, the market for secure identification products and solutions may ultimately be dominated by approaches other than the approach marketed by us.

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

Strategic Risks

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

The markets for our products are characterized by rapidly changing technology and the need to meet market requirements and to differentiate our products and solutions through technological enhancements, and in some cases, price. Our customers needs change, new technologies are introduced into the market, and industry standards continue to evolve. As a result, product life cycles are often short and difficult to predict, and frequently we must develop new products quickly in order to remain competitive in light of new market requirements. Rapid changes in technology, or the adoption of new industry standards, could render our existing products obsolete and unmarketable. Changes in market requirements could render our existing solutions obsolete or could require us to expend more on research and development efforts. For example, a significant portion of our revenues results from the sale of access control panels that include certain design elements that are more than a decade old. These controllers are typically used in a network architecture that may become outdated or obsolete. If a product is deemed to be obsolete or unmarketable, then we might have to reduce revenue expectations or write down inventories for that product. We may also lose market share.

Our future success will depend upon our ability to enhance our current products and solutions and to develop and introduce new offerings with clearly differentiated benefits that address the increasingly sophisticated needs of our customers and that keep pace with technological developments, new competitive product offerings and emerging industry standards. We must be able to demonstrate that our products have

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features or functions that are clearly differentiated from existing or anticipated competitive offerings, or we may be unsuccessful in selling these products. Our failure to develop, manufacture, launch and sell next-generation security products and solutions could significantly affect our financial performance. In addition, in cases where we are selected to supply products or solutions based on features or capabilities that are still under development, we must be able to complete our design, delivery and implementation process on a timely basis, or risk losing current and any future revenue from those offerings. In developing our offerings, we must collaborate closely with our customers, suppliers and other strategic partners to ensure that critical development, marketing and distribution projects proceed in a coordinated manner. Also, this collaboration is important because these relationships increase our exposure to information necessary to anticipate trends and plan product development. If any of our current relationships terminate or otherwise deteriorate, or if we are unable to enter into future alliances that provide us with comparable insight into market trends, our product development and marketing efforts may be adversely affected, and we could lose sales. We expect that our product development efforts will continue to require substantial investments and we may not have sufficient resources to make the necessary investments.

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

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

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

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

We are also focused on expanding sales of professional services, identity management and RFID products and solutions. The market for some of these solutions is at an early stage of development. Additionally, we have a strategy of expanding sales of existing product lines into new geographic markets and diversifying and expanding our customer base, for example expanding sales of our smart card readers to address authentication programs in the government and enterprise sectors in Asia and increasing sales of our Multicard RFID solutions to address programs utilizing mobile phones.

Because the markets for our products and solutions are still emerging, demand for our offerings is subject to variability from period to period. There is no assurance that demand will become more predictable as additional security and RFID programs demonstrate success. If demand for products and solutions to enable identity management applications does not develop further and grow sufficiently, our revenue and gross profit margins could decline or fail to grow. We cannot predict the future growth rate, if any, or size or composition of the market for any of our offerings. Our target markets have not consistently grown or developed as quickly as we have expected, and we have experienced delays in the development of new products designed to take advantage of new market opportunities. Since new target markets are still evolving, it is difficult to assess the competitive environment or the size of the market that may develop. The demand and market acceptance for our offerings, as

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is common for new technologies, is subject to high levels of uncertainty and risk and may be influenced by various factors, including, but not limited to, the following:

- general economic conditions, for example economic uncertainty;
- our ability to demonstrate to our potential customers and partners the value and benefits of new products;
- the ability of our competitors to develop and market competitive solutions for emerging applications in our target markets and our ability to win business in advance of and against such competition;
- the adoption and/or continuation of industry or government regulations or policies requiring the use of products or solutions such as our smart card readers or access control solutions;
- the timing of large scale security programs involving smart cards, RFID and related technology by governments, banks and enterprises; and
- the ability of financial institutions, corporate enterprises, the U.S. government and other governments to agree on industry specifications and to develop and deploy security applications that will drive demand for products and solutions such as ours.

Our acquisition strategy and strategic investments expose us to significant risks.

A significant component of our ongoing business strategy is to seek to buy businesses, products and technologies that complement or augment our existing businesses, products and technologies. This acquisition strategy exposes us to significant risks, including possible dilution of stockholder value, disruption to our business, difficulty in integrating acquired businesses and failure to realize the benefits we expect from strategic transactions. Occurrence of any of these risks could harm our operating results.

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

Any future acquisition could expose us to additional significant risks, including, without limitation:

- the use of our limited cash balance or potentially dilutive stock offerings to fund such acquisitions;
- costs of any necessary financing, which may not be available on reasonable terms or at all;
- accounting charges we might incur in connection with such acquisitions;

the difficulty and expense of integrating personnel, technologies, customer, supplier and distributor relationships, marketing efforts and facilities acquired through acquisitions;

integrating internal controls over financial reporting; discovering and correcting deficiencies in internal controls and other regulatory compliance, data adequacy and integrity, product quality and product liabilities;

diversion of management resources;

failure to realize anticipated the benefits of the acquisition;

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costly fees for legal and transaction-related services; and

the unanticipated assumption of liabilities.

Any of the foregoing could have a material adverse effect on our financial condition and results of operations. We may not be successful with any such acquisition. Acquisitions and strategic investments may also lead to substantial increases in non-current assets, including goodwill. Write-downs of these assets due to unforeseen business developments may materially and adversely impact our financial condition and results of operations.

Additionally, we have in the past acquired or made, and from time to time in the future may acquire or make, investments in companies, products and technologies that we believe are complementary to our existing businesses, products and technologies. These investments may not yield positive results. For example, on October 1, 2008, we entered into a Stock Purchase Agreement with TranZfinity, Inc., a privately held entity, pursuant to which we purchased 33.7% of the outstanding shares of TranZfinity common stock for an aggregate purchase price of $2.5 million. During the fourth quarter of 2009, we determined that the value of our investment in TranZfinity was impaired and we recorded a charge for the impairment to write-off 100% of our investment and our proportionate losses realized by TranZfinity of $2.2 million.

We may not recognize anticipated benefits from the strategic disposition or divestiture of portions of our business.

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

Operational Risks

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

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

We currently expect that our current capital resources and available borrowings should be sufficient to meet our operating and capital requirements at least through the end of 2011. We may, however, seek additional debt or equity financing prior to that time. There can be no assurance that additional capital will be available to us on favorable terms or at all. The sale of additional debt or equity securities may cause dilution to existing stockholders.

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A material impairment in the carrying value of acquired goodwill or other intangible assets could negatively affect our consolidated operating results and net worth.

A significant portion of our assets is goodwill and other intangible assets, which are reviewed on an annual basis and whenever events and changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying value of these assets exceeds the current fair value, the asset is considered impaired and is reduced to fair value, resulting in a non-cash charge to earnings during the period in which any impairment is determined. Events and conditions that could result in impairment include a sustained drop in the market price of our common stock, increased competition or loss of market share, product innovation or obsolescence, or a decline of our business related to acquired companies. We cannot accurately predict the amount and timing of any impairment of assets.

We have incurred operating losses and may not achieve or maintain profitability.

We have a history of losses. In the future, we may not be able to achieve expected results, including any guidance or outlook we may provide from time to time; we may continue to incur losses and we may be unable to achieve or maintain profitability.

Our quarterly and annual operating results fluctuate.

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

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

new product announcements or introductions;

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

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

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

technological changes in the markets for our products and solutions;

the rate of adoption of industry-wide standards;

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

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strategic acquisitions, sales and dispositions;

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

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

loss of key personnel; and

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

Due to these and other factors, our revenues may not increase or even remain at their current levels. Because a majority of our operating expenses are fixed, a small variation in our revenues can cause significant variations in our operational results from quarter to quarter and our operating results may vary significantly in future periods. Therefore, our historical results may not be a reliable indicator of our future performance.

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

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

If we do not accurately anticipate the correct mix of products that will be sold, we may be required to record charges related to excess inventories.

Due to the unpredictable nature of the demand for our products, we are required to place orders with our suppliers for components, finished products and services in advance of actual customer commitments to purchase these products. Significant unanticipated fluctuations in demand could result in costly excess production or inventories. In order to minimize the negative financial impact of excess production, we may be required to significantly reduce the sales price of the product to increase demand, which in turn could result in a reduction in the value of the original inventory purchase. If we were to determine that we could not utilize or sell this inventory, we may be required to write down its value, which we have done in the past. Writing down inventory or reducing product prices could adversely impact our cost of revenues and financial condition.

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

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

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

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

A significant portion of our sales typically comes from a small number of customers and the loss of one or more of these customers or variability in the timing of orders could negatively impact our operating results.

Sales to a relatively small number of customers historically have accounted for a significant percentage of our revenues. We believe that the addition of customers and markets from our Hirsch, Bluehill ID, RockWest and Smartag acquisitions has improved the diversity of our customer base and reduced our reliance on a small number of customers in our business overall. However, in our ID Products business, we expect that a small number of customers will continue to account for a significant percentage of sales in any given period, for the foreseeable future. The loss of a customer or reduction of orders from a significant customer, including those due to product performance issues, changes in customer buying patterns, or market, economic or competitive conditions in our market segments, could significantly lower our revenues in any period and would increase our dependence on a smaller group of our remaining customers. Variations in the timing or patterns of customer orders could also increase our dependence on other customers in any particular period. Dependence on a small number of customers and variations in order levels period to period could result in decreased revenues, decreased margins, and/or inventory or receivables write-offs and otherwise harm our business and operating results.

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

We derive a substantial portion of our revenues from indirect sales to U.S. federal, state and local governments and government agencies, as well as from subcontracts under federal government prime contracts. Large government programs are a primary target for our ID Management business, as higher security systems employing smart card, RFID or other access control technologies are increasingly used to enable applications ranging from authorizing building and network access for federal employees to paying taxes online, to citizen identification, to receiving health care. We believe that the success and growth of our business will continue to be influenced by our successful procurement of government business either directly or through our indirect sales channels. Accordingly, changes in government purchasing policies or government budgetary constraints could directly affect our financial performance.

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

- changes in fiscal policies or decreases in available government funding or grants;
- changes in government programs or applicable requirements;
- delays in developing technology standards;
- the adoption of new laws or regulations or changes to existing laws or regulations pertaining to security;
- changes in political or social attitudes with respect to security or electronic identification issues;
- potential delays or changes in the government appropriations process; and

delays in the payment of its invoices by government payment offices.

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These and other factors could cause governments and governmental agencies to reduce their purchases or to defer or cancel new identity management programs that might have utilized our products, any of which could have an adverse effect on our business, financial condition and results of operations. Many of our government end customers are subject to stringent budgetary constraints. The award of additional orders from government agencies could be adversely affected by existing or future spending reduction efforts or budget cutbacks at these agencies.

For example, over the past several quarters, purchases of our SCM Microsystems external smart card readers for use by U.S. government agencies have been significantly lower than in previous periods, due to ongoing project and budget delays, which were in part related to the change in presidential administration, and a movement by the U.S. government towards purchasing computer equipment with embedded reader capabilities. We continue to believe that we remain a leading supplier of smart card reader technology to the U.S. government market and that we are not losing share to competitors. However, lower overall market demand and the replacement of external smart card reader sales with sales of lower-priced interface chips for embedded readers is a trend that we do not believe will reverse.

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

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

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

We derive a substantial portion of revenue through the sale of Hirsch solutions for U.S. government programs that involve competitive bidding and may be subject to significant delay, which may produce volatility in our revenues and earnings.

In our Hirsch business a substantial portion of revenues are related to orders received from government agencies through our indirect channel partners, and to a lesser extent, from direct sales governed by pricing as

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published in the General Services Administration (GSA) schedules. Government orders are frequently awarded only after a formal competitive bidding process, which typically is protracted and dependent upon necessary funds being available to the public agency. We may not be awarded orders for which we bid directly and our dealers may not be successful in their bids that would utilize our offerings. In some cases, unsuccessful bidders for government agency orders are provided the opportunity to formally protest certain order awards through various agency, administrative and judicial channels. The protest process may substantially delay a successful bidder s award or result in cancellation of the order entirely. Furthermore, local government agency awards may be contingent upon availability of matching funds from federal or state entities and law enforcement and other government agencies are subject to political, budgetary, purchasing and delivery constraints. Any of these factors can make it difficult to predict our quarterly and annual revenues and operating results.

Our U.S. government business is dependent upon receipt of certain governmental approvals or certifications, and failure to receive such approvals or certifications could have a material adverse effect on our sales in those market segments for which such approvals or certifications are customary or required.

While we are not able to quantify the amount of sales made to the U.S. government due to the indirect nature of our selling process, we believe that orders for U.S. government agencies represent a significant portion of our revenues. Failing to obtain certain government approvals or certifications could have a material adverse effect in those environments for which such approvals or certifications are customary or required. As newer versions of existing products, or new products in development, are released, they may require certifications or approvals. In addition, the U.S. government may introduce new requirements that some existing products will be required to meet. If we fail to obtain any required approvals or certifications for our products, our business will suffer.

Our business could be adversely affected by negative audits by government agencies; we could be required to reimburse the U.S. government for costs that we have expended on government orders; and our ability to compete successfully for future orders could be materially impaired.

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

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

A significant portion of our sales is made through an indirect sales channel, and the loss of dealers, systems integrators, resellers, or other channel partners could result in decreased revenue.

We currently use an indirect sales channel that includes dealers, systems integrators, value added resellers and resellers to sell a significant portion of our products and solutions, primarily into markets or customers where

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the channel partner may have closer relationships or greater access than we do. Some of these channel partners also sell our competitors products, and if they favor our competitors products for any reason, they may fail to market our products as effectively or to devote resources necessary to provide effective sales, which would cause our sales to suffer. Indirect selling arrangements are intended to benefit both us and the channel partner, and may be long- or short-term relationships, depending on market conditions, competition in the marketplace and other factors. If we are unable to maintain effective indirect sales channels, there could be a reduction in the amount of product we are able to sell, and our revenues could decrease.

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

Many of our products are manufactured outside the U.S. by contract manufacturers. Our reliance on foreign manufacturing poses a number of risks, including, but not limited to:

- difficulties in staffing;
- currency fluctuations;
- potentially adverse tax consequences;
- unexpected changes in regulatory requirements;
- tariffs and other trade barriers;
- export controls;
- political and economic instability;
- lack of control over the manufacturing process and ultimately over the quality of our products;
- late delivery of our products, whether because of limited access to our product components, transportation delays and interruptions, difficulties in staffing, or disruptions such as natural disasters;
- capacity limitations of our manufacturers, particularly in the context of new large contracts for our products, whether because our manufacturers lack the required capacity or are unwilling to produce the quantities we desire; and
- obsolescence of our hardware products at the end of the manufacturing cycle.

The use of contract manufacturing requires us to exercise strong planning and management in order to ensure that our products are manufactured on schedule, to correct specifications and to a high standard of quality. If any of our contract manufacturers cannot meet our production requirements, we may be required to rely on other contract manufacturing sources or identify and qualify new contract manufacturers. We may be unable to identify or qualify new contract manufacturers in a timely manner or at all or with reasonable terms and these new manufacturers may not allocate sufficient capacity to us in order to meet our requirements. Any significant delay in our ability to obtain adequate supplies of our products from our current or alternative manufacturers would materially and adversely affect our business and operating results. In addition,

if we are not successful at managing the contract manufacturing process, the quality of our products could be jeopardized or inventories could be too low or too high, which could result in damage to our reputation with our customers and in the marketplace, as well as possible write-offs of excess inventory.

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

We rely upon a limited number of suppliers for some key components of our products. For example, we currently utilize the foundry services of external suppliers to produce our ASICs for smart cards readers and inlays, and we use chips and antenna components from third-party suppliers in our contactless smart card readers. Our reliance on a limited number of suppliers may expose us to various risks including, without limitation, an

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inadequate supply of components, price increases, late deliveries and poor component quality. In addition, some of the basic components used in our reader products, such as semiconductors, may at any time be in great demand. This could result in components not being available to us in a timely manner or at all, particularly if larger companies have ordered more significant volumes of those components, or in higher prices being charged for components. For example, limited availability of certain semiconductor chips used in our TagStar and SCM Microsystems products had a negative impact in our sales during 2010. Disruption or termination of the supply of components or software used in our products could delay shipments of our products. These delays could have a material adverse effect on our business and operating results and could also damage relationships with current and prospective customers.

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

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

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

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

In our business, deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the implementation of our solutions in such projects and to deploy appropriate resources, including our own project managers and third-party subcontractors, in a timely manner. Any defects or errors or failures to meet clients expectations could result in damage to our reputation or even claims for substantial monetary damages against us. In addition, we sometimes provide guarantees to customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit derived from a particular project. Moreover, a portion of our revenues are derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

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

Products such as SCM Microsystems smart card readers, Hirsch s access control panels and our RFID inlays may contain defects for many reasons, including defective design or manufacture, defective material or software inoperability issues. Often, these defects are not detected until after the products have been shipped. If any of our products contain defects or perceived defects or have reliability, quality or compatibility problems or

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perceived problems, our reputation might be damaged significantly, we could lose or experience a delay in market acceptance of the affected product or products and we might be unable to retain existing customers or attract new customers. In addition, these defects could interrupt or delay sales. In the event of an actual or perceived defect or other problem, we may need to invest significant capital, technical, managerial and other resources to investigate and correct the potential defect or problem and potentially divert these resources from other development efforts. If we are unable to provide a solution to the potential defect or problem that is acceptable to our customers, we may be required to incur substantial product recall, repair and replacement and even litigation costs. These costs could have a material adverse effect on our business and operating results.

We provide warranties on certain product sales, which range from 12 to 24 months, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or to replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line combined with liability estimates based on the prior twelve months sales activities. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to recognize additional cost of sales may be required in future periods.

In addition, because our customers rely on our smart card readers to prevent unauthorized access to PCs, networks or facilities, a malfunction of or design defect in our products (or even a perceived defect) could result in legal or warranty claims against us for damages resulting from security breaches. If such claims are adversely decided against us, the potential liability could be substantial and have a material adverse effect on our business and operating results. Furthermore, the possible publicity associated with any such claim, whether or not decided against us, could adversely affect our reputation. In addition, a well-publicized security breach involving smart card-based or other security systems could adversely affect the market s perception of products like ours in general, or our products in particular, regardless of whether the breach is actual or attributable to our products. Any of the foregoing events could cause demand for our products to decline, which would cause our business and operating results to suffer.

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

Our business model includes the management of separate product lines that address disparate market opportunities that are geographically dispersed. While there is some shared technology across our products, each product line requires significant research and development efforts to address the evolving needs of our customers and markets. To support our development and sales efforts, we maintain company offices and business operations in several locations around the world, including Australia, Brazil, Canada, Germany, Hong Kong, India, Japan, the Netherlands, Singapore, Switzerland and the U.S. We also must manage contract manufacturers in multiple countries, including China and Singapore. Managing our various development, sales, administrative and manufacturing operations places a significant burden on our financial systems and has contributed to a level of operational spending that is disproportionately high compared to our current revenue levels.

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

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

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

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

We conduct a substantial portion of our business in Europe and Asia. Approximately 45% of our revenue in 2010 and 40% of our revenue in 2009 was derived from customers located outside the U.S.

Because a significant number of our principal customers are located in other countries, we anticipate that international sales will continue to account for a substantial portion of our revenues. As a result, a significant portion of our sales and operations may continue to be subject to risks associated with foreign operations, any of which could impact our sales and/or our operational performance. These risks include, but are not limited to:

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

Personnel Risks

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

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

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

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

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

The success of our company depends, in part, on the continued service of key managerial, marketing and sales personnel. Competition for qualified management, technical, sales and marketing employees is intense. We

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cannot assure you that we will be able to attract, retain and integrate employees to develop and continue our business and successfully implement strategic acquisitions.

Risks of Financial and Capital Markets

Our stock price has been and is likely to remain volatile.

Over the past few years, the NASDAQ Stock Market and the Frankfurt Stock Exchange have experienced significant price and volume fluctuations that have particularly affected the market prices of the stocks of technology companies. Volatility in our stock price on either or both exchanges may result from a number of factors, including, among others:

- low volumes of trading activity in our stock, particularly in the U.S.;
- variations in our or our competitors financial and/or operational results;
- the fluctuation in market value of comparable companies in any of our markets;
- expected, perceived or announced relationships or transactions with third parties;
- comments and forecasts by securities analysts;
- trading patterns of our stock on the NASDAQ Stock Market or the Frankfurt Stock Exchange;
- the inclusion or removal of our stock from market indices, such as groups of technology stocks or other indices;
- loss of key personnel;
- announcements of technological innovations or new products by us or our competitors;
- announcements of dispositions, organizational restructuring, headcount reductions, litigation or write-off of investments;
- litigation developments; and
- general market downturns.

In the past, companies that have experienced