SCM MICROSYSTEMS INC
Form 10-Q
November 14, 2006

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

**FORM 10 Q**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006**
**OR**

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

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

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

**41740 Christy Street, Fremont, CA 94538**
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES INCLUDING ZIP CODE)
**(510) 360-2300**
(REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE)
**466 Kato Terrace, Fremont, CA 94539**
(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer o Non-accelerated filer þ
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ
At November 7, 2006, 15,693,932 shares of common stock were outstanding.

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**PART I. FINANCIAL INFORMATION**
**Item 1. Financial Statements**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Net revenue | $ 7,396 | $ 8,051 | $ 24,185 | $ 20,534 |
| Cost of revenue | 5,271 | 4,948 | 16,251 | 12,501 |
| Gross profit | 2,125 | 3,103 | 7,934 | 8,033 |
| Operating expenses: | | | | |
| Research and development | 1,085 | 1,048 | 3,115 | 2,947 |
| Selling and marketing | 2,292 | 1,609 | 6,053 | 5,282 |
| General and administrative | 2,208 | 2,492 | 6,340 | 6,958 |
| Amortization of intangible assets | 170 | 163 | 495 | 513 |
| Restructuring and other charges | 400 | 22 | 1,066 | 174 |
| Total operating expenses | 6,155 | 5,334 | 17,069 | 15,874 |
| Loss from operations | (4,030) | (2,231) | (9,135) | (7,841) |
| Interest and other income | 367 | 416 | 809 | 2,029 |
| Loss from continuing operations before income taxes | (3,663) | (1,815) | (8,326) | (5,812) |
| Provision for income taxes | (17) | (135) | (46) | (128) |
| Loss from continuing operations | (3,680) | (1,950) | (8,372) | (5,940) |
| Income (loss) from discontinued operations, net of income taxes | (213) | (8) | 2,793 | (2,604) |
| Gain (loss) on sale of discontinued operations, net of income taxes | 24 | (89) | 5,287 | (74) |
| Net loss | $ (3,869) | $ (2,047) | $ (292) | $ (8,618) |
| Loss per share from continuing operations: | | | | |
| Basic and diluted | $ (0.24) | $ (0.12) | $ (0.54) | $ (0.39) |
| Gain (loss) per share from discontinued operations: | | | | |

| | | | | |
|---|---|---|---|---|
| Basic | $ (0.01) | $ (0.01) | $ 0.52 | $ (0.17) |
| Diluted | $ (0.01) | $ (0.01) | $ 0.52 | $ (0.17) |
| Net loss per share: | | | | |
| Basic | $ (0.25) | $ (0.13) | $ (0.02) | $ (0.56) |
| Diluted | $ (0.25) | $ (0.13) | $ (0.02) | $ (0.56) |
| Shares used to compute basic loss per share | 15,648 | 15,542 | 15,623 | 15,517 |
| Shares used to compute diluted loss per share | 15,648 | 15,542 | 15,646 | 15,517 |
| Comprehensive loss: | | | | |
| Net loss | $ (3,869) | $ (2,047) | $ (292) | $ (8,618) |
| Unrealized gain (loss) on investments | 32 | (59) | 61 | 150 |
| Foreign currency translation adjustment | 75 | (81) | 272 | (1,958) |
| Total comprehensive gain (loss) | $ (3,762) | $ (2,187) | $ 41 | $ (10,426) |

See notes to condensed consolidated financial statements.

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

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 28,961 | $ 13,660 |
| Short-term investments | 7,316 | 18,780 |
| Restricted short-term investments (see Note 10) | 2,000 | |
| Accounts receivable, net of allowances of $1.088 and $972 as of September 30, 2006 and December 31, 2005, respectively | 4,344 | 6,904 |
| Inventories | 2,226 | 6,005 |
| Other current assets | 2,808 | 2,038 |
| Total current assets | 47,655 | 47,387 |
| Property and equipment, net | 1,466 | 3,050 |
| Intangible assets, net | 432 | 879 |
| Other assets | 1,882 | 1,418 |
| Total assets | $ 51,435 | $ 52,734 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 4,959 | $ 5,700 |
| Accrued compensation and related benefits | 1,705 | 2,708 |
| Accrued restructuring and other charges | 3,600 | 3,897 |
| Accrued professional fees | 1,524 | 1,644 |
| Accrued royalties | 1,029 | 1,244 |
| Other accrued expenses | 2,710 | 2,565 |
| Income taxes payable | 2,479 | 2,258 |
| Total current liabilities | 18,006 | 20,016 |
| Deferred tax liability | 100 | 101 |

| | | | | |
|---|---|---|---|---|
| Commitments and contingencies (see Notes 10 and 12) | | | | |
| Total liabilities | | 18,106 | | 20,117 |
| Stockholders equity: | | | | |
| Common stock, $0.001 par value: 40,000 shares authorized; 15,663 and 15,593 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively | | 16 | | 16 |
| Additional paid-in capital | | 228,347 | | 227,676 |
| Treasury stock | | (2,777) | | (2,777) |
| Accumulated deficit | | (193,048) | | (192,756) |
| Other cumulative comprehensive gain | | 791 | | 458 |
| Total stockholders equity | | 33,329 | | 32,617 |
| Total liabilities and stockholders equity | $ | 51,435 | $ | 52,734 |

See notes to condensed consolidated financial statements.

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

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income (loss) | $ (292) | $ (8,618) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Loss (gain) from discontinued operations | (8,080) | 2,678 |
| Depreciation and amortization | 795 | 1,396 |
| Loss (gain) on disposal of fixed assets | 46 | |
| Stock compensation expense | 485 | |
| Deferred income taxes | (1) | (20) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (216) | 1,896 |
| Inventories | 64 | (21) |
| Other assets | (910) | 85 |
| Accounts payable | 361 | 1,018 |
| Accrued expenses | (3,548) | (4,863) |
| Income taxes payable | 218 | 129 |
| Net cash used in operating activities from continuing operations | (11,078) | (6,320) |
| Net cash provided by (used in) operating activities from discontinued operations | 13,074 | (2,828) |
| Net cash provided by (used in) operating activities | 1,996 | (9,148) |
| Cash flows from investing activities: | | |
| Capital expenditures | (65) | (57) |
| Proceeds from disposal of fixed assets | 11 | 76 |
| Maturities of short-term investments | 14,392 | 6,768 |
| Purchase of restricted short-term investments | (2,000) | |
| Purchases of short-term investments | (2,878) | (12,399) |
| Net cash provided by (used in) investing activities from continuing operations | 9,460 | (5,612) |
| Net cash provided by (used in) investing activities from discontinued operations | 3,484 | (6) |
| Net cash provided by (used in) investing activities | 12,944 | (5,618) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of equity securities, net | 174 | 158 |
| Net cash provided by financing activities | 174 | 158 |

| | | |
|---|---|---|
| Effect of exchange rates on cash and cash equivalents | 187 | (1,350) |
| Net increase (decrease) in cash and cash equivalents | 15,301 | (15,958) |
| Cash and cash equivalents at beginning of period | 13,660 | 31,181 |
| Cash and cash equivalents at end of period | $ 28,961 | $ 15,223 |
| Supplemental disclosures of cash flow information: | | |
| Income tax refunds received | $ | $ |
| Income taxes paid | $ 106 | $ 34 |

See notes to condensed consolidated financial statements.

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# SCM MICROSYSTEMS, INC. AND SUBSIDIARIES
# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
# SEPTEMBER 30, 2006

## 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulations S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the financial statements and footnotes thereto included in SCM Microsystems ( SCM or the Company ) Annual Report on Form 10-K for the year ended December 31, 2005.

*Discontinued Operations*

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its Digital Television solutions ( DTV solutions ) business to Kudelski S.A. ( Kudelski ) for total consideration of $11 million in cash, of which $9 million has been paid. Based on recent actions by Kudelski and the terms of the purchase agreement, the Company has made demand for payment of the remaining $2 million. The obligation to make the additional $2 million payment is disputed by Kudelski. Accordingly, the Company has not recorded the $2 million as receivable. In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144 ( SFAS 144 ), *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and nine months ended September 30, 2006 and 2005, this business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation. See Note 3 for further discussion of this transaction.

*Stock-based Compensation*

During the first quarter of fiscal 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, the Financial Accounting Standards Board s ( FASB ) SFAS No. 123 revised 2004 ( SFAS 123(R) ), *Share-Based Payment,* which replaced SFAS No. 123 ( SFAS 123 ), *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 ( APB 25 ), *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The Company elected to use the modified-prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123(R) apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The adoption of SFAS 123(R) did not have a material impact on the Company s consolidated financial position, results of operations and cash flows. See Note 2 for further information regarding the Company s stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had recorded stock-based compensation expense in accordance with SFAS 123.

*Recent Accounting Pronouncements*

In April 2006, the FASB issued FASB Staff Position No. FIN 46(R)-6 ( FSP FIN 46(R)-6 ), which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, as amended ( FIN 46(R) ). The variability that is considered in applying FIN 46(R) affects the determination of (a) whether the entity is a variable interest entity, (b) which interests are variable interests in the entity and (c) which party, if any, is the primary beneficiary of the variable interest entity. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary. FSP FIN 46(R)-6 provides additional guidance to consider for determining variability. FSP FIN 46(R)-6 is effective beginning the first day of the first reporting period beginning after June 15, 2006. After evaluating FSP FIN

46(R)-6, the Company determined that there is no impact to its consolidated financial position, results of operations or cash flows from its adoption.

In July 2006, the FASB issued FASB Interpretation No. 48 *Accounting for Uncertain Tax Positions* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109 *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 to its financial position and results of operations.

In June 2006, the Financial Accounting Standards Board, or FASB, ratified Emerging Issues Task Force, or EITF, Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* ( Issue No. 06-03 ). Under Issue No. 06-03, a company must disclose its accounting policy regarding the gross or net presentation of certain taxes. If taxes included in gross revenues are significant, a company must disclose the amount of such taxes for each period for which an income statement is presented (i.e., both interim and annual periods). Taxes within the scope of this Issue are those that are imposed on and concurrent with a specific revenue-producing transaction. Taxes assessed on an entity s activities over a period of time, such as gross receipts taxes, are not within the scope of the issue. Issue No. 06-03 is effective for the first annual or interim reporting period beginning after December 15, 2006. The Company is currently evaluating the impact of EITF, Issue No. 06-03 to its financial position and results of operations.

In September 2006, the Securities and Exchange Commission ( SEC ) published Staff Accounting Bulletin ( SAB ) No 108. SAB 108 expresses the staff views regarding the process of quantifying financial statement misstatements. The bulletin prescribes the use of rollover and iron curtain approaches in quantifying misstatements. Rollover approach quantifies a misstatement based on the amount of the error originating in the current year income statement. Iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the year, irrespective of the misstatement s year(s) of origination. The statement is effective immediately. The Company did not have any misstatements that were determined to be material on the basis of either of the approaches mentioned above.

**2. Stock Based Compensation**

The Company has a stock-based compensation program that provides its Board of Directors discretion in creating employee equity incentives. This program includes incentive and non-statutory stock options under various plans, the majority of which are stockholder approved. Stock options are generally time-based, vesting 25% each year over four years and expire ten years from the grant date. Additionally, the Company has an Employee Stock Purchase Plan ( ESPP ) that allows employees to purchase shares of common stock at 85% of the fair market value at the lower of either the date of enrollment or the date of purchase. Shares issued as a result of stock option exercises and the ESPP are newly issued shares. As of September 30, 2006, the Company had approximately 3.7 million shares of common stock reserved for future issuance under the stock option plans and ESPP.

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

The Company previously accounted for its employee stock option and employee stock purchase plans under the intrinsic value recognition and measurement principles of APB 25 and related Interpretations, and adopted the disclosure-only provisions of SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*. The pro forma effects on net loss and loss per share for stock options and ESPP awards were disclosed in a footnote to the unaudited condensed consolidated financial statements.

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

Compensation expense recognized in the unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2006 is based on awards ultimately expected to vest and reflects estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to adoption of SFAS 123(R) the Company accounted for forfeitures as they occurred.

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

As a result of adopting SFAS 123(R), the Company s loss from continuing operations before the income tax provision and net loss from discontinued operations for the three and nine months ended September 30, 2006 were $0.1 million and $0.5 million higher, respectively, than they would have been had the Company continued to account for share-based compensation under APB 25. Basic and diluted net loss per share from continuing operations for the three and nine months ended September 30, 2006 would have been $0.01 and $0.03 lower, respectively, if the Company had not adopted SFAS 123(R). There was no effect on the condensed consolidated statements of cash flows for the nine months ended September 30, 2006 from adopting SFAS 123(R).

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

| | Three months Ended September 30, 2006 | Nine months Ended September 30, 2006 |
|---|---|---|
| Cost of revenue | $ 10 | $ 24 |
| Research and development | 29 | 92 |
| Selling and marketing | 38 | 119 |
| General and administrative | 66 | 250 |
| Stock-based compensation expense before income taxes | $ 143 | $ 485 |
| Income tax benefit | | |
| Stock-based compensation expense after income taxes | $ 143 | $ 485 |

The following table illustrates the effect on reported net loss and net loss per share for the three and nine months ended September 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation (in thousands, except per share data):

| | Three months Ended September 30, 2005 | Nine months Ended September 30, 2005 |
|---|---|---|
| Net loss as reported | $ (2,047) | $ (8,618) |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects | | |

| | | | | |
|---|---|---|---|---|
| Less: Stock-based compensation expense determined under fair value method for all awards | | (333) | | (1,172) |
| Pro forma net loss | $ | (2,380) | $ | (9,790) |
| Net loss per share, as reported basic and diluted | $ | (0.13) | $ | (0.56) |
| Pro forma loss per share basic and diluted | $ | (0.15) | $ | (0.63) |

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***Stock Option Plans***

A total of 3,344,674 shares of common stock are currently reserved for future grant under the Plans.
Summary of activity under stock option plans for the nine months ended September 30, 2006 is as follows:

| | Options Available for Grant | Number of Options Outstanding | Weighted Average Exercise Price per share | Aggregate Intrinsic Value | Average Remaining Contractual Life (in years) |
|---|---|---|---|---|---|
| Balance at December 31, 2005 | 3,036,308 | 2,822,761 | $ 16.26 | | 6.07 |
| Options granted | (288,384) | 288,384 | $ 3.24 | | |
| Options cancelled or expired | 596,750 | (596,750) | $ 6.90 | | |
| Options exercised | | (21,130) | $ 2.78 | $ 7,293 | |
| Balance at September 30, 2006 | 3,344,674 | 2,493,265 | $ 17.11 | $ 207,176 | 5.37 |
| Vested or expected to vest at September 30, 2006 | | 2,360,452 | $ 17.89 | $ 171,948 | |
| Exerciseable at September 30, 2006 | | 1,973,504 | $ 20.76 | $ 98,325 | 4.45 |

The weighted-average grant date fair value per option for options granted during the three and nine months ended September 30, 2006 was $1.69 and $1.72, respectively. The weighted-average grant date fair value per option for options granted during the three and nine months ended September 30, 2005 was $2.36 and $2.79, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was $7,100 and $7,300, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2005 was $0 and $2,000, respectively. Cash proceeds from the exercise of stock options were $58,000 and $58,700 for the three and nine months ended September 30, 2006, respectively. Cash proceeds from the exercise of stock options were $0 and $6,000 for the three and nine months ended September 30, 2005, respectively. No income tax benefit was realized from the stock option exercises during the three and nine months ended September 30, 2006 and 2005. Stock-based compensation expense related to stock options recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was $0.1 million and $0.5 million, respectively. At September 30, 2006, there was $0.9 million of unrecognized stock-based compensation expense, net of estimated forfeitures related to non-vested options, that is expected to be recognized over a weighted-average period of 1.93 years.

The fair value of option grants was estimated by using the Black-Scholes-Merton model with the following weighted-average assumptions for the three and nine months ended September 30, 2006 and 2005, respectively:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Expected volatility | 64% | 89% | 69% | 90% |
| Dividend yield | 0 | 0 | 0 | 0 |
| Risk-free interest rate | 4.62% | 4.10% | 4.85% | 3.85% |

| | | | | |
|---|---|---|---|---|
| Expected term (in years) | 3.92 | 4.00 | 3.92 | 4.00 |

*Expected Volatility*: The Company s computation of expected volatility for the three and nine months ended September 30, 2006 is based on the historical volatility of the Company s stock for a time period equivalent to the expected life. Prior to the three and nine months ended September 30, 2006, the Company had used its historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information.

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

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

*Expected Term:* The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined for the three and nine month ended September 30, 2006 based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior.

***1997 Employee Stock Purchase Plan***

Under the Company s ESPP, up to 1,021,887 shares of the Company s common stock may be issued. The Company s ESPP permits eligible employees to purchase common stock through payroll deductions up to 10% of their base wages at a purchase price of 85% of the lower of fair market value of the common stock at the beginning or end of each offering period. The Company has a two year rolling plan with four purchases every six months within the offering period. If the fair market value per share is lower on the purchase date than the beginning of the offering period, the current offering period terminates and a new two year offering period will commence. The Company s ESPP restricts the maximum amount of shares purchased by an individual to $25,000 worth of common stock each year. As of September 30, 2006, 384,616 shares were available for future issuance under the Company s ESPP.

The fair value of issuances under the Company s ESPP is estimated on the issuance date by applying the principles of FASB Technical Bulletin 97-1 ( FTB 97-1 ), *Accounting under Statement 123 for Certain Employee Stock Purchase Plan with a Look Back Option*, and using the Black-Scholes-Merton options pricing model. Stock-based compensation expense related to the Company s ESPP recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was $26,000 and $101,000, respectively. At September 30, 2006, there was $53,000 of unrecognized stock-based compensation expense related to outstanding ESPP shares that is expected to be recognized over a nineteen month period.

**3. Discontinued Operations**

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its DTV solutions business to Kudelski for total expected consideration of $11 million in cash, of which $9 million has been paid. Based on recent actions by Kudelski and the terms of the purchase agreement, the Company has made demand for payment of the remaining $2 million. The obligation to make the additional $2 million payment is disputed by Kudelski. Accordingly, the Company has not recorded the $2 million as receivable. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, for the three and nine months ended September 30, 2006 and 2005, the DTV solutions business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

Based on the carrying value of the assets and the liabilities attributed to the DTV solutions business on May 22, 2006, and the estimated costs and expenses incurred in connection with the sale, the Company recorded a net pretax gain of approximately $5.5 million, excluding the $2 million noted above.

The operating results for the discontinued operations of the DTV solutions business for the three and nine months ended September 30, 2006 and for the same period of 2005 are as follows (in thousands):

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Net revenue | $1,877 | $5,261 | $12,288 | $13,802 |
| Operating gain (loss) | $ (115) | $ 107 | $ (1,276) | $ (2,452) |
| Net income (loss) before income taxes | $ (141) | $ 162 | $ 2,919 | $ (2,337) |
| Income tax benefit (provision) | $ (8) | $ (3) | $ 75 | $ 167 |
| Income (loss) from discontinued operations | $ (149) | $ 158 | $ 2,994 | $ (2,171) |

During 2003, the Company completed two transactions to sell its retail Digital Media and Video business. On July 25, 2003, the Company completed the sale of its digital video business to Pinnacle Systems and on August 1, 2003, the Company completed the sale of its retail digital media reader business to Zio Corporation. As a result of these sales, the Company has accounted for the retail Digital Media and Video business as discontinued operations.

The operating results for the discontinued operations of the retail Digital Media and Video business for the three and nine months ended September 30, 2006 and for the same period of 2005 are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenue | $ | $ | $ | $ |
| Operating loss | $(75) | $ (59) | $(201) | $(244) |
| Net loss before income taxes | $(51) | $ (96) | $(134) | $(365) |
| Income tax provision | $(13) | $ (70) | $ (67) | $ (70) |
| Loss from discontinued operations | $(64) | $(166) | $(201) | $(435) |

**4. Short-Term Investments**

At September 30, 2006, approximately 50% of the short-term investment portfolio matures in 2006 and the remaining 50% in 2007. The fair value of short-term investments at September 30, 2006 and December 31, 2005 was as follows (in thousands):

| | September 30, 2006 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gain on Investments | Unrealized Loss on Investments | Estimated Fair Value |
| Corporate notes | $ 1,783 | $ 0 | $ (2) | $ 1,781 |
| U.S. government agencies | 5,550 | | (15) | 5,535 |
| Total | $ 7,333 | $ 0 | $ (17) | $ 7,316 |

| | December 31, 2005 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gain on Investments | Unrealized Loss on Investments | Estimated Fair Value |
| Corporate notes | $ 9,369 | $ 6 | $ (34) | $ 9,341 |
| U.S. government agencies | 9,490 | | (51) | 9,439 |
| Total | $ 18,859 | $ 6 | $ (85) | $ 18,780 |

***Cumulative Adjustment to Interest Income and Other Cumulative Comprehensive Gain***

In July 2005, during a review of the Company s investment holdings and the calculation of interest income and unrealized gains and losses on investments, the Company discovered an error in the recording of the amortization of investment premiums and discounts and the related interest income and unrealized gain (loss) on investments. As a result, interest income and unrealized loss on investments and the balance of unrealized loss included in other cumulative comprehensive gain for the years ended December 31, 2004 and 2003 have been overstated. The cumulative overstatement of interest income and unrealized loss on investments for periods prior to the three months ended June 30, 2005 was approximately $0.3 million. The effect of the error was not material to any relevant prior period and had the amounts been recorded correctly in the prior periods, there would have been no effect on reported comprehensive loss or total stockholder s equity. To correct this error, the Company recorded the cumulative $0.3 million as a reduction in interest income and a decrease in unrealized loss on investments during the three-month period ended June 2005.

During each quarter, SCM evaluates investments for possible asset impairment by examining a number of factors, including the current economic conditions and markets for each investment, as well as its cash position and anticipated cash needs for the short and long term. In addition, the Company evaluates severity and duration in each reporting period. At September 30, 2006,

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approximately $6.5 million of the short-term investment portfolio has an unrealized loss and approximately $4.5 million of those investments have been in an unrealized loss position for more than one year. Of the $17,000 unrealized loss at September 30, 2006, approximately $14,000 relates to investments that have been in an unrealized loss position for more than one year. The Company believes these fair value declines are the result of rising short-term interest rates. For the three and nine months ended September 30, 2006 and 2005, no impairment of the investments was identified based on the evaluations performed.

**5. Inventories**

Inventories consist of (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Raw materials | $ 1,405 | $ 2,430 |
| Work-in-process | | 2,435 |
| Finished goods | 821 | 1,140 |
| Total | $ 2,226 | $ 6,005 |

The reduction in inventories and in particular work-in-progress is primarily the result of the outsourcing of the Company s manufacturing operations from its Singapore facility to contract manufacturers.

**6. Property and Equipment**

Property and equipment consists of (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Land | $ 122 | $ 260 |
| Building and leasehold improvements | 1,827 | 3,187 |
| Furniture, fixtures and office equipment | 3,115 | 5,333 |
| Automobiles | 1 | 58 |
| Purchased software | 3,138 | 4,018 |
| Total | 8,203 | 12,856 |
| Accumulated depreciation | (6,737) | (9,806) |
| Property and equipment, net | $ 1,466 | $ 3,050 |

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**7. Intangible Assets**

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

| | | September 30, 2006 | | | December 31, 2005 | | |
|---|---|---|---|---|---|---|---|
| | Amortization Period | Gross Carrying Value | Accumulated Amortization | Net | Gross Carrying Value | Accumulated Amortization | Net |
| Customer relations | 60 months | $ 1,582 | $ (1,387) | $ 195 | $ 1,476 | $ (1,071) | $ 405 |
| Core technology | 60 months | 1,793 | (1,556) | 237 | 1,673 | (1,199) | 474 |
| Total intangible assets | | $ 3,375 | $ (2,943) | $ 432 | $ 3,149 | $ (2,270) | $ 879 |

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

Amortization expense related to intangible assets for continuing operations was $0.2 million and $0.5 million for the three and nine months ended September 30, 2006, respectively, and $0.2 million and $0.5 million for the three and nine months ended September 30, 2005.

Estimated future amortization of intangible assets is as follows (in thousands):

| Fiscal Year | Amount |
|---|---|
| 2006 (remaining 3 months) | $ 170 |
| 2007 | 262 |
| Total | $ 432 |

**8. Restructuring and Other Charges**

*Continuing Operations*

During the three and nine months ended September 30, 2006, SCM incurred net restructuring and other charges related to continuing operations of approximately $0.4 million and $1.3 million, respectively. During the three and nine months ended September 30, 2005, SCM incurred net restructuring and other charges related to continuing operations of approximately $0.2 million and $0.4 million, respectively.

Accrued liabilities related to restructuring actions and other activities during the nine months ended September 30, 2006 and during the year ended December 31, 2005 consist of the following (in thousands):

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| | Lease/Contract Commitments | Severance | Other Costs | Total |
|---|---|---|---|---|
| Balances as of January 1, 2005 | $ 52 | $ 431 | $ 5,132 | $ 5,615 |
| Provision for 2005 | | 699 | 25 | 724 |
| Changes in estimates | 7 | (12) | 127 | 122 |
| | 7 | 687 | 152 | 846 |
| Payments and other changes in 2005 | (27) | (966) | (4,994) | (5,987) |
| Balances as of December 31, 2005 | 32 | 152 | 290 | 474 |
| Provision for Q1 2006 | | 519 | | 519 |
| Changes in estimates | (2) | | | (2) |
| | (2) | 519 | | 517 |
| Payments and other changes in Q1 2006 | (4) | (52) | 7 | (49) |
| Balances as of March 31, 2006 | $ 26 | $ 619 | $ 297 | $ 942 |
| Provision for Q2 2006 | | 342 | | 342 |
| Changes in estimates | | | | |
| | | 342 | | 342 |
| Payments and other changes in Q2 2006 | (3) | (248) | 10 | (241) |
| Balances as of June 30, 2006 | $ 23 | $ 713 | $ 307 | $ 1,043 |
| Provision for Q3 2006 | 33 | 394 | | 427 |
| Changes in estimates | | | | |
| | 33 | 394 | | 427 |
| Payments and other changes in Q3 2006 | (38) | (806) | 4 | (840) |
| Balances as of September 30, 2006 | $ 18 | $ 301 | $ 311 | $ 630 |

For the three and nine months ended September 30, 2006, restructuring and other charges primarily related to severance costs in connection with a reduction in force resulting from the Company s decision to transfer all manufacturing operations from its Singapore facility to contract manufacturers as well as the decision to transfer the corporate headquarter functions from California to Germany. Approximately $0.2 million of the restructuring amount relates to severance for manufacturing personnel for the nine month period and is therefore recorded in cost of revenue. The remaining $1.1 million in the nine month period is recorded in operating expenses and is primarily made up of severance for non-manufacturing personnel. The Company believes the restructuring activity is substantially completed and that any future costs incurred will be insignificant.

As shown in the table above in Payments or write offs in 2005 Other Costs, in April 2005, SCM made a payment to the French government of approximately $4.7 million as then calculated, related to Value Added Tax ( VAT ) in respect of sales transactions with a former customer. In connection with this payment, SCM entered into an agreement with the customer whereby the customer agreed to seek a refund from the French government for the VAT paid with respect to the products it purchased from the Company, and then remit the refunded amount to SCM. On June 9, 2006, the customer remitted to the Company the full amount including currency gains totaling $5.0 million, of which $4.2 million was recognized as other income from discontinued operations. See Note 12 for further discussion.

*Discontinued Operations*

During the three and nine months ended September 30, 2006, SCM incurred restructuring and other credits of approximately $25,000 and restructuring and other charges of approximately $31,000, respectively, related to discontinued operations. During the three and nine months ended September 30, 2005, SCM incurred restructuring and other charges related to discontinued operations of approximately $0.1 million and $0.1 million, respectively.

Accrued liabilities related to the Digital Media and Video restructuring actions and other activities during the nine months ended September 30, 2006 and during the year ended December 31, 2005 consist of the following (in thousands):

| | Legal Settlements | Lease/Contract Commitments | Other Costs | Total |
|---|---|---|---|---|
| Balances as of January 1, 2005 | $ | $ 3,960 | $ 304 | $ 4,264 |
| Provision for 2005 | 1,700 | | 648 | 2,348 |
| Changes in estimates | | (111) | | (111) |
| | 1,700 | (111) | 648 | 2,237 |
| Payments and other changes | (1,700) | (651) | (727) | (3,078) |
| Balances as of December 31, 2005 | | 3,198 | 225 | 3,423 |
| Provision for Q1 2006 | | | 5 | 5 |
| Changes in estimates | | (24) | | (24) |
| | | (24) | 5 | (19) |
| Payments and other changes in Q1 2006 | | (124) | (190) | (314) |
| Balances as of March 31, 2006 | $ | $ 3,050 | $ 40 | $ 3,090 |
| Provision for Q2 2006 | | | | |
| Changes in estimates | | 75 | | 75 |
| | | 75 | | 75 |
| Payments and other changes in Q2 2006 | | (107) | | (107) |
| Balances as of June 30, 2006 | $ | $ 3,018 | $ 40 | $ 3,058 |
| Provision for Q3 2006 | | | | |
| Changes in estimates | | (25) | | (25) |
| | | (25) | | (25) |
| Payments and other changes in Q3 2006 | | (63) | | (63) |
| Balances as of June 30, 2006 | $ | $ 2,930 | $ 40 | $ 2,970 |

Discontinued operation costs for the three and nine months ended September 30, 2006 primarily related to changes in estimates for lease obligations.

**9. Segment Reporting, Geographic Information and Major Customers**

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

On May 22, 2006, the Company completed the sale of substantially all the assets and some of the liabilities associated with its DTV solutions business to Kudelski. In accordance with SFAS No. 144, *Accounting for the*

*Impairment or Disposal of Long Lived Assets*, for the three and nine months ended September 30, 2006 and 2005, this business has been presented as discontinued operations in the condensed consolidated statements of operations and cash flows and all prior periods have been reclassified to conform to this presentation.

The Company s continuing operations provide secure digital access solutions to OEM customers in two markets segments: PC Security and Flash Media Interface. The executive staff reviews financial information and business performance along these two business segments. The Company evaluates the performance of its segments at the revenue and gross margin level. The Company s reporting systems do not track or allocate operating expenses or assets by segment. The Company does not include intercompany transfers between segments for management purposes.

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Summary information by segment for the three and nine months ended September 30, 2006 and for the same periods of 2005 is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| PC Security: | | | | |
| Net revenue | $5,096 | $3,898 | $16,438 | $12,566 |
| Gross profit | 1,621 | 1,414 | 6,480 | 4,147 |
| Gross profit % | 32% | 36% | 39% | 33% |
| Flash Media Interface: | | | | |
| Net revenue | $2,300 | $4,153 | $ 7,747 | $ 7,968 |
| Gross profit | 504 | 1,689 | 1,454 | 3,886 |
| Gross profit % | 22% | 41% | 19% | 49% |
| Total: | | | | |
| Net revenue | $7,396 | $8,051 | $24,185 | $20,534 |
| Gross profit | 2,125 | 3,103 | 7,934 | 8,033 |
| Gross profit % | 29% | 39% | 33% | 39% |

Geographic net revenue is based on selling location. Information regarding net revenue by geographic region is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenue | | | | |
| United States | $ 3,242 | $ 3,807 | $ 10,407 | $ 8,825 |
| Europe | 3,045 | 3,094 | 10,212 | 6,996 |
| Asia-Pacific | 1,109 | 1,150 | 3,566 | 4,713 |
| Total | $ 7,396 | $ 8,051 | $ 24,185 | $ 20,534 |
| % of net revenue | | | | |
| United States | 44% | 48% | 43% | 43% |
| Europe | 41% | 38% | 42% | 34% |
| Asia-Pacific | 15% | 14% | 15% | 23% |

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Customer A based in the USA | 14% | * | 12% | * |
| Customer B based in the USA | * | 27% | * | 20% |
| Customer C based in Asia | * | * | * | 10% |
| Customer D based in Europe | 13% | 17% | * | * |

| | | | | |
|---|---|---|---|---|
| Total | 27% | 44% | 12% | 30% |

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

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

(5) That, for the purpose of determining liability of the registrant under the Securities Act of 1933 to any purchaser in the initial distribution of the securities the undersigned registrant undertakes that in a primary offering of securities of the undersigned registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

(i) Any preliminary prospectus or prospectus of the undersigned registrant relating to the offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to the offering prepared by or on behalf of the undersigned registrant or used or referred to by the undersigned registrant;

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(iii) The portion of any other free writing prospectus relating to the offering containing material information about the undersigned registrant or its securities provided by or on behalf of the undersigned registrant; and

(iv) Any other communication that is an offer in the offering made by the undersigned registrant to the purchaser.

(b) The undersigned registrant hereby further undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant s annual report pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(c) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the provisions described under Item 15 in the registration statement above, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted against the registrant by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

## SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, Duke Energy Corporation certifies that it has reasonable grounds to believe that it meets all of the requirements for filing on Form S-3 and has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Charlotte, State of North Carolina, on the 1st day of March, 2013.

Duke Energy Corporation
(Registrant)

By: /s/ JAMES E. ROGERS*
Name: James E. Rogers
Title: Chairman, President and Chief Executive Officer

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been duly signed by the following persons in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ JAMES E. ROGERS*<br>James E. Rogers | Director and Chairman, President and Chief Executive Officer<br>(Principal Executive Officer) | March 1, 2013 |
| /s/ LYNN J. GOOD*<br>Lynn J. Good | Executive Vice President and Chief Financial Officer (Principal Financial Officer) | March 1, 2013 |
| /s/ STEVEN K. YOUNG*<br>Steven K. Young | Vice President, Chief Accounting Officer and Controller (Principal Accounting Officer) | March 1, 2013 |

| Signature | Title | Date |
|---|---|---|
| William Barnet, III* | Director | March 1, 2013 |
| G. Alex Bernhardt, Sr.* | Director | March 1, 2013 |
| Michael G. Browning* | Director | March 1, 2013 |
| Harris E. DeLoach, Jr. | Director | March 1, 2013 |
| Daniel R. DiMicco* | Director | March 1, 2013 |
| John H. Forsgren* | Director | March 1, 2013 |
| Ann Maynard Gray* | Director | March 1, 2013 |
| James H. Hance, Jr.* | Director | March 1, 2013 |
| James B. Hyler, Jr. | Director | March 1, 2013 |
| E. Marie McKee | Director | March 1, 2013 |
| E. James Reinsch* | Director | March 1, 2013 |
| James T. Rhodes* | Director | March 1, 2013 |
| Carlos A. Saladrigas | Director | March 1, 2013 |
| Philip R. Sharp* | Director | March 1, 2013 |

* The undersigned, by signing his name hereto, does hereby sign this document on behalf of the registrant and on behalf of each of the above-named persons indicated above by asterisks, pursuant to a power of attorney duly executed by the registrant and such persons, filed with the Securities and Exchange Commission as an exhibit hereto.

By: /s/ DAVID S. MALTZ
Attorney-in-Fact
March 1, 2013

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**EXHIBIT INDEX**

| Exhibit Number | Exhibit |
|---|---|
| 4.1 | Duke Energy PremierNotes Plan dated as of April 4, 2011 (filed as Exhibit 4.1 to Registration Statement on Form S-3 of the registrant, Registration No.333-173282, and incorporated by reference herein). |
| 4.2 | Indenture dated as of April 4, 2011 (filed as an exhibit to Registration Statement on Form S-3 of the registrant, Registration No.333-173282, and incorporated by reference herein). |
| 5 | Opinion of Robert T. Lucas III, Esq. |
| 12 | Computation of Ratio of Earnings to Fixed Charges of Duke Energy Corporation, incorporated by reference to Exhibit 12.1 to the Annual Report on Form 10-K of Duke Energy Corporation for the fiscal year ended December 31, 2012 (Commission File No. 001-32853). |
| 23 | Consent of Deloitte & Touche LLP. |
| 24.1 | Powers of Attorney of Directors and Officers of Duke Energy Corporation. |
| 24.2 | Resolution of Duke Energy Corporation regarding Power of Attorney. |
| 25 | Form T-1 Statement of Eligibility of The Bank of New York Mellon Trust Company, N.A. |