ITERIS, INC.
Form 10-Q
August 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 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: 001-08762

ITERIS, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**95-2588496** (I.R.S. Employer Identification No.)
1515 South Manchester Avenue **Anaheim, California** (Address of principal executive office)	**92802** (Zip Code)

(714) 774-5000

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act) 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 x 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 x**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of August 10, 2006, the registrant had 29,133,339 shares of common stock outstanding

---

ITERIS, INC.
Quarterly Report on Form 10-Q
For the Three Months Ended June 30, 2006

Table of Contents

PART I. **FINANCIAL INFORMATION**

ITEM 1. **FINANCIAL STATEMENTS**

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS AT JUNE 30, 2006 AND MARCH 31, 2006

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ITEM 2. **MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

ITEM 3. **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

ITEM 4. **CONTROLS AND PROCEDURES**

PART II. **OTHER INFORMATION**

ITEM 1. **LEGAL PROCEEDINGS**

ITEM 1A. **RISK FACTORS**

ITEM 2. **UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

ITEM 3. **DEFAULTS UPON SENIOR SECURITIES**

ITEM 4. **SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

ITEM 5. **OTHER INFORMATION**

ITEM 6. **EXHIBITS**

Unless otherwise indicated in this report, the Company, we, us and our collectively refer to Iteris, Inc., formerly known as Iteris Holdings, Inc. and Odetics, Inc., and its former subsidiary, Meyer, Mohaddes Associates, Inc., which was dissolved effective April 2006.

AutoVue®, Iteris®, Vantage® and eAccess are among the trademarks of Iteris, Inc. Any other trademarks or trade names mentioned herein are the property of their respective owners.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ITERIS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	June 30, 2006 (unaudited)	March 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 225**	$ 131
Trade accounts receivable, net of allowance for doubtful accounts of $482 and $429 at June 30, 2006 and March 31, 2006, respectively	**10,512**	11,426
Costs and estimated earnings in excess of billings on uncompleted contracts	**3,585**	2,693
Inventories, net of reserve for inventory obsolescence of $618 and $592 at June 30, 2006 and March 31, 2006, respectively	**2,989**	2,814
Deferred income taxes	**886**	790
Prepaid expenses and other current assets	**953**	368
Total current assets	**19,150**	18,222
Property and equipment, net	**1,795**	1,783
Deferred income taxes	**1,178**	818
Intangible assets, net of accumulated amortization of $297 and $261 at June 30, 2006 and March 31, 2006, respectively	**515**	551
Goodwill	**27,774**	27,774
Other assets	**417**	485
Total assets	**$ 50,829**	$ 49,633
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Trade accounts payable	**$ 3,446**	$ 3,620
Accrued payroll and related expenses	**3,352**	3,481
Accrued liabilities	**2,788**	2,304
Billings in excess of costs and estimated earnings on uncompleted contracts	**655**	893
Revolving line of credit	**3,509**	2,662
Current portion of long-term debt	**2,271**	1,969
Total current liabilities	**16,021**	14,929
Non-current liabilities	**288**	12
Deferred compensation plan liability	**754**	820
Deferred gain on sale of building	**378**	449
Long-term debt	**1,536**	2,171
Convertible debentures, net	**9,255**	9,203
Total liabilities	**28,232**	27,584
Commitments and contingencies		
Redeemable common stock, 1,219 shares issued and outstanding at June 30, 2006 and March 31, 2006	**3,414**	3,414
Stockholders equity:		
Preferred stock, $1.00 par value, 2,000 shares authorized, none issued and outstanding at June 30, 2006 and March 31, 2006		
Common stock, $0.10 par value, 50,000 shares authorized, 27,571 and 27,432 shares issued and outstanding at June 30, 2006 and March 31, 2006, respectively	**2,757**	2,743
Additional paid-in capital	**126,914**	126,664
Common stock held in trust, 311 shares at June 30, 2006 and March 31, 2006	**(374)**	(374)
Notes receivable from employees	**(45)**	(49)
Accumulated deficit	**(110,077)**	(110,356)
Accumulated other comprehensive income	**8**	7
Total stockholders equity	**19,183**	18,635
Total liabilities and stockholders equity	**$ 50,829**	$ 49,633

See accompanying notes to unaudited condensed consolidated financial statements.

ITERIS, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Three Months Ended June 30, 2006	2005
Net sales and contract revenues:		
Net sales	**$ 8,600**	$ 7,525
Contract revenues	**5,216**	4,554
Total net sales and contract revenues	**13,816**	12,079
Costs and expenses:		
Cost of net sales (a)	**4,758**	3,755
Cost of contract revenues (a)	**3,339**	2,969
Gross profit	**5,719**	5,355
Operating expenses:		
Selling, general and administrative (a)	**4,001**	3,828
Research and development (a)	**1,003**	1,746
Deferred compensation plan	**(66)**	62
Amortization of intangible assets	**36**	37
Total operating expenses	**4,974**	5,673
Operating income (loss)	**745**	(318)
Other income (expense):		
Other expense, net	**(690)**	(48)
Interest expense, net	**(386)**	(352)
Total other income (expense), net	**(1,076)**	(400)
Loss before income taxes	**(331)**	(718)
Income tax benefit (expense)	**610**	(8)
Net income (loss)	**$ 279**	$ (726)
Earnings (loss) per common share:		
Basic	**$ 0.01**	$ (0.03)
Diluted	**$ 0.01**	$ (0.03)
Weighted average common shares outstanding:		
Basic	**28,393**	28,062
Diluted	**32,368**	28,062
(a) Includes stock-based compensation expense as follows:		
Cost of net sales	**5**	9
Cost of contract revenues	**29**	70
Selling, general and administrative expense	**54**	139
Research and development expense	**12**	47

See accompanying notes to unaudited condensed consolidated financial statements.

ITERIS, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended June 30, 2006	2005
Cash flows from operating activities		
Net income (loss)	**$ 279**	$ (726)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Change in deferred tax assets	**(456)**	
Depreciation and amortization of property and equipment	**130**	162
Stock-based compensation	**100**	265
Amortization of deferred gain on sale leaseback transaction	**(71)**	(71)
Amortization of debt discount	**52**	52
Amortization of intangible assets	**36**	37
Amortization of deferred financing costs	**34**	35
Changes in operating assets and liabilities:		
Accounts receivable	**914**	(831)
Net costs and estimated earnings in excess of billings	**(1,130)**	(419)
Inventories	**(175)**	496
Prepaid expenses and other assets	**(551)**	(168)
Accounts payable and accrued liabilities	**239**	(695)
Net cash used in operating activities	**(599)**	(1,863)
Cash flows from investing activities		
Purchases of property and equipment	**(142)**	(212)
Cash flows from financing activities		
Proceeds from borrowings on line of credit, net	**847**	1,353
Payments on long-term debt	**(333)**	(333)
Change in checks drawn in excess of available bank balances	**153**	885
Proceeds from stock option and warrant exercises	**168**	124
Net cash provided by financing activities	**835**	2,029
Increase (decrease) in cash	**94**	(46)
Cash at beginning of period	**131**	46
Cash at end of period	**$ 225**	$
Supplemental cash flow information:		
Cash paid (received) during the period:		
Interest	**$ 301**	$ 254
Income taxes	**40**	44
Supplemental schedule of non-cash investing and financing activities:		
Fair value of warrants issued in settlement of liabilities		28

See accompanying notes to unaudited condensed consolidated financial statements.

ITERIS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Iteris, Inc., formerly known as Iteris Holdings, Inc. and Odetics, Inc. (Iteris or the Company), is a leading provider of outdoor machine vision systems and sensors that optimize the flow of traffic and enhance driver safety. Using proprietary software and Intelligent Transportation Systems (ITS) industry expertise, the Company provides video sensor systems, transportation management and traveler information systems and other engineering consulting services to the ITS industry. The ITS industry is comprised of companies applying a variety of technologies to enable the safe and efficient movement of people and goods. The Company uses its outdoor image recognition software expertise to develop proprietary algorithms for video sensor systems that improve vehicle safety and the flow of traffic. Using its knowledge of the ITS industry, the Company designs and implements transportation management systems that help public agencies reduce traffic congestion and provide greater access to traveler information. The Company was originally incorporated in Delaware in 1987 as Odetics, Inc. and in September 2003 changed its name to Iteris Holdings, Inc. to reflect its focus on the ITS industry and its capital structure at that time. On October 22, 2004, the Company completed a merger with its majority-owned subsidiary, Iteris, Inc. (the Iteris Subsidiary), and officially changed its corporate name from Iteris Holdings, Inc. to Iteris, Inc.

Basis of Presentation

The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Securities and Exchange Commission (SEC) Form 10-Q and Article 10 of SEC Regulation S-X. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary to present fairly the consolidated financial position of the Company as of June 30, 2006, the consolidated results of operations for the three months ended June 30, 2006 and 2005, and the consolidated cash flows for the three months ended June 30, 2006 and 2005. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted pursuant to the rules and regulations of the SEC. The results of operations for the three months ended June 30, 2006, are not necessarily indicative of those to be expected for the entire year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended March 31, 2006, which was filed with the SEC on June 29, 2006.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in the preparation of the consolidated financial statements include the allowance for doubtful accounts, deferred tax assets, inventory and warranty reserves, costs to complete long-term contracts, overhead rates used in cost-plus contracts, contract reserves and estimates of future cash flows used to assess the recoverability of long-lived assets, the valuation of debt and equity instruments and the realization of goodwill.

Revenue Recognition

Product revenues and related costs of sales are recognized upon the transfer of title, which generally occurs upon shipment or, if required, upon acceptance by the customer, provided that the Company believes collectibility of the net sales amount is probable. Accordingly, at the date revenue is recognized, the significant uncertainties concerning the sale have been resolved.

Contract revenues are derived primarily from long-term contracts with governmental agencies. Contract revenues include costs incurred plus a portion of estimated fees or profits determined on the percentage of completion method of accounting based on the relationship of costs incurred to date to total estimated costs. Any anticipated losses on contracts are charged to earnings when identified. Changes in job performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to costs

and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when their realization is reasonably assured.

In addition to product and contract revenue, the Company derives revenue from technology access fees, the provision of specific non-recurring contract engineering services and royalties. Technology access fee revenues are recognized evenly over the period in which they are earned. Non-recurring contract engineering revenues are recognized in the period in which the related services are performed. Royalty revenues are recorded in the period in which the royalty is earned, based on unit sales of the Company s products. Technology access fee revenues, contract engineering revenues and royalty revenues are included in net sales in the accompanying condensed consolidated statements of operations.

Revenues from follow-on service and support, for which the Company charges separately, are recorded in the period in which the services are performed.

Concentration of Credit Risk

Accounts receivable are primarily derived from revenues earned from customers located throughout North America and Europe. The Company generally does not require collateral or other security from customers. Collectibility of receivable balances is estimated through review of invoices outstanding greater than a certain period of time and ongoing credit evaluations of customers financial condition. Reserves are maintained for potential credit losses, and such losses have historically been within management s expectations.

Fair Values of Financial Instruments

The fair values of cash and cash equivalents, receivables, inventories, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity. The fair values of line of credit agreements and long-term debt approximate carrying value because the related rates of interest approximate current market rates. The fair value of convertible debentures approximates carrying value because the effective interest rate, taking into account recorded debt discounts, approximates current market rates. The estimated fair value of redeemable common stock was $2.9 million and $3.2 million at June 30, 2006 and March 31, 2006, respectively, based on the closing price of the Company s common stock on those dates.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property and Equipment

Property and equipment are recorded at cost and are depreciated over the estimated useful life ranging from three to eight years. Leasehold improvements are depreciated over the term of the related lease or the estimated useful life of the improvement, whichever is shorter. Beginning April 1, 2006, the Company began depreciating property and equipment using the straight-line method of depreciation. Prior to this date, the Company used the double declining balance method of depreciation. As a result of this change in estimate, depreciation expense declined by $80,000, with no impact on earnings per share, for the three months ended June 30, 2006.

Goodwill and Long-Lived Assets

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Intangible Assets*, goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis in the Company s fourth fiscal quarter or more frequently if indicators of impairment exist, of which none have been identified. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of the Company s reporting units with each respective reporting unit s carrying amount, including goodwill. The fair value of reporting units is generally determined using the income approach. If the carrying amount of a reporting unit exceeds the reporting unit s fair value, the second step of the goodwill impairment test is performed to determine the amount of any impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of the reporting unit s goodwill with the carrying amount of that goodwill.

The Company evaluates long-lived assets for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* which requires impairment evaluation on long-lived assets used in operations when indicators of impairment are present. Reviews are performed to determine whether the carrying value of assets is impaired, based on a comparison to undiscounted expected future cash flows. If this comparison indicates that there is impairment, the impaired asset is written down to fair value, which is typically calculated using discounted expected future cash flows and a discount rate based upon the Company s weighted average cost of capital adjusted for risks associated with the related operations. Impairment is based on the excess of the carrying amount over the fair value of those assets.

Income Taxes

The Company utilizes the liability method of accounting for income taxes as set forth in SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities using enacted tax rates. A valuation allowance is recorded when it is more likely than not that all or a portion of the deferred tax assets will not be realized.

Research and Development Expenditures

Research and development expenditures are charged to expense in the period incurred.

Shipping and Handling Costs

Shipping and handling costs are included in cost of sales in the period during which products ship.

Warranty

The Company generally provides a one to three year warranty from the original invoice date on all products, materials and workmanship. Products sold to certain original equipment manufacturer (OEM) customers sometimes carry longer warranties. Defective products will be either repaired or replaced, generally at the Company s option, upon meeting certain criteria. The Company accrues a provision for the estimated costs that may be incurred for product warranties relating to a product as a component of cost of sales at the time revenue for that product is recognized. The accrued warranty provision is included within accrued expenses on the accompanying condensed consolidated balance sheets.

Repair and Maintenance Costs

The Company incurs repair and maintenance costs in the normal course of business. Should the activity result in a permanent improvement to one of the Company s leased facilities, the cost is capitalized as a leasehold improvement and amortized over its useful life or the remainder of the lease period, whichever is shorter. Non-permanent repair and maintenance costs are charged to expense as incurred.

Reclassifications

Certain amounts in the prior period financial statements have been reclassified to conform with current year presentation.

Comprehensive Income

The only component of accumulated other comprehensive income is foreign currency translation adjustments.

Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), supersedes Accounting Principles Board Opinion No. 25 (APB 25), and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values (i.e., pro forma disclosure is no longer an alternative to financial statement recognition). As further discussed in Note 5, the Company adopted SFAS 123R effective April 1, 2006 using the modified prospective method.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS 109. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48 and will adopt this Interpretation in the first quarter of its fiscal year ending March 31, 2008.

2. Supplemental Financial Information

Inventories

The following table presents details of the Company s inventories:

	June 30, 2006 (In thousands)	March 31, 2006
Materials and supplies	**$ 2,512**	$ 2,258
Work in process	**182**	217
Finished goods	**295**	339
	$ 2,989	$ 2,814

Goodwill and Identifiable Intangible Assets

The following table sets forth the Company s intangible assets that are subject to amortization:

	June 30, 2006		March 31, 2006	
	Gross Carrying Amount (In thousands)	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Developed technology	**$ 495**	**$ (204)**	$ 495	$ (179)
Patents	**317**	**(93)**	317	(82)
Total	**$ 812**	**$ (297)**	$ 812	$ (261)

Amortization expense for intangible assets subject to amortization was $36,000 and $37,000 for the three month periods ended June 30, 2006 and June 30, 2005, respectively. Future estimated amortization expense for the remainder of the current fiscal year, the next four fiscal years and thereafter is as follows:

Fiscal Year Ending March 31: (In thousands)	
Remainder of 2007	$ 110
2008	147
2009	147
2010	59
2011	46
Thereafter	6
	$ 515

At June 30, 2006, goodwill of $27.8 million was comprised of $18.0 million associated with the October 2004 merger between the Company and its Iteris Subsidiary; $9.6 million associated with the acquisitions of the Rockwell International Transportation Systems Group, Meyer Mohaddes Associates, Inc. and the Viggen Systems Consulting Group; and $200,000 associated with the purchase of the assets of Mil-Lektron, a complementary product to the Company s Vantage video detection business.

Warranty Reserve Activity

The following table presents activity in accrued warranty obligations:

	Three Months Ended June 30, 2006	2005
	(In thousands)	
Balance at beginning of period	**$ 519**	$ 326
Additions charged to cost of sales	**135**	75
Warranty claims	**(64)**	(59)
Balance at end of period	**$ 590**	$ 342

9

Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share:

	Three Months Ended June 30, 2006	2005
	(In thousands, except per share amounts)	
Numerator:		
Net income (loss)	**$ 279**	$ (726)
Denominator:		
Weighted average common shares used in basic computation	**28,393**	28,062
Dilutive stock options	**3,417**	
Dilutive warrants	**558**	
Weighted average common shares used in dilutive computation	**32,368**	28,062
Basic and diluted earnings (loss) per share	**$ 0.01**	$ (0.03)

The following shares were excluded from the computation of diluted earnings (loss) per share as their effect would have been antidilutive:

	Three Months Ended June 30, 2006	2005
	(In thousands)	
Stock options	**525**	7,323
Warrants	**1,380**	3,624
Convertible debentures	**2,729**	2,729

3. Revolving Line of Credit and Long-Term Debt

Revolving Line of Credit

The Company renewed its line of credit agreement with its primary bank effective August 1, 2005, which provided for borrowings of up to $5.0 million. This line of credit agreement expired on July 31, 2006 but was extended until August 31, 2006. The Company is currently in negotiations with its bank to replace this line of credit, but cannot assure that a new credit line will be obtained in a timely manner, on acceptable terms or at all.

Under this line of credit, the Company may borrow against its eligible accounts receivable and the value of its eligible inventory, as defined in the credit agreement. Interest on borrowed amounts is payable monthly at the current stated prime rate plus 3.0%. Additionally, the Company is obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeds the average daily principal balance during the preceding month.

There are no monthly collateral management fees and no pre-payment or early termination fees. On June 30, 2006, the available credit under this line of credit agreement was $4.1 million, of which $600,000 was unused.

Long-Term Debt

The Company s long-term debt consists of the following:

	June 30, 2006 (In thousands)	March 31, 2006
Convertible debentures, net	**$ 9,255**	$ 9,203
Bank term note	**2,396**	2,708
Promissory note to landlord	**1,292**	1,292
Other	**119**	140
	13,062	13,343
Less current portion	**(2,271)**	(1,969)
	$ 10,791	$ 11,374

10

Convertible Debentures, Net. In May 2004, the Company sold and issued subordinated convertible debentures in the aggregate original principal amount of $10.1 million. In connection with the issuance of the debentures, the Company issued warrants to purchase an aggregate of 639,847 shares of its common stock, the value of which was recorded as a debt discount against the face amount of the debentures on the date of issuance and is being amortized to interest expense over the term of the convertible debentures.

The debentures are due in full on May 19, 2009, provide for 6.0% annual interest, payable quarterly, and are convertible into the Company s common stock at an initial conversion price of $3.61 per share, subject to certain adjustments, including adjustments for dilutive issuances. From May 19, 2007 until May 18, 2008, the debentures may be redeemed by the Company, at its option, at 120% of the principal amount; and from May 19, 2008, until the maturity date, the Company may redeem the debentures at 110% of the principal amount. As of June 30, 2006, $250,000 of convertible debentures had been converted into 69,252 shares of common stock leaving $9.9 million of the originally issued convertible debentures outstanding at June 30, 2006.

Bank Term Note. In October 2004, the Company entered into a $5.0 million term note payable with a bank. The note is due on May 27, 2008, and provides for monthly principal payments of approximately $104,000. Interest accrues at the current stated prime rate plus 0.25% (8.50% at June 30, 2006).

Both the bank term note and the line of credit are held by one bank under the same credit agreement and are secured by substantially all of the assets of the Company.

Promissory Note to Landlord. The Company has a $1.3 million unsecured promissory note payable to its landlord. Under the terms of the note agreement, interest is payable quarterly and accrues at a rate of prime plus 2.0% (10.25% at June 30, 2006). Beginning on October 1, 2006, the Company is required to make four equal quarterly payments of principal and accrued interest. All outstanding accrued interest and principal becomes payable in full on July 1, 2007.

Scheduled aggregate maturities of long-term debt principal as of June 30, 2006 were as follows:

Year Ending March 31, **(In thousands)**	
Remainder of 2007	**$ 1,636**
2008	**1,940**
2009	**231**
2010	**9,850**
	$ 13,657
Less: unamortized debt discount	**(595)**
	$ 13,062

4. Commitments and Contingencies

Litigation and Other Contingencies

On June 29, 2004, a supplier to Mariner Networks, Inc., a former subsidiary of the Company that was discontinued in the fiscal year ended March 31, 2002, filed a complaint in Orange County Superior Court against the Company alleging various breaches of written contract claims arising out of alleged purchase orders. The plaintiff in this lawsuit sought monetary damages aggregating approximately $850,000 plus attorney fees and related costs. On July 20, 2006, the Company entered into a preliminary settlement in connection with this matter. In full settlement of this dispute, the Company agreed to pay $125,000 on or before October 20, 2006, plus an additional $350,000 to be paid in equal monthly installments of $9,700 over three years beginning in November 2006. Additionally, the Company agreed to issue shares of its common stock valued at $213,000 in August 2006, based on the closing sales price of the Company s common stock on the date of issuance. In connection with this settlement, the Company has recorded $688,000 to other expense in the accompanying condensed consolidated statement of operations for the three months ended June 30, 2006.

From time to time, the Company has been involved in litigation relating to claims arising out of its operations in the normal course of business. The Company currently is not a party to any legal proceedings, the adverse outcome of which, in management s opinion, individually or in the aggregate, would have a material adverse effect on its consolidated results of operations, financial position or cash flows.

Furthermore, from time to time, the Company has experienced unforeseen developments in contingencies related to its former subsidiaries. For example, the Company has been the subject of a number of routine tax audits for time periods and jurisdictions related to the businesses of its former subsidiaries, some of which are still in process. Although the development and ultimate outcome of these and other unforeseen matters cannot be predicted with any certainty,

11

management does not believe that the Company is presently involved in any matters related to its former subsidiaries that would have a material adverse effect on the Company s consolidated results of operations, financial position or cash flows.

Operating Lease Commitments

The Company has lease commitments for facilities in various locations throughout the United States. Future commitments under these non-cancelable operating leases at June 30, 2006, including the lease for the Company s Anaheim facilities were as follows:

Fiscal Year Ending March 31, **(In thousands)**	
Remainder of 2007	**$ 1,112**
2008	**932**
2009	**127**
2010	**85**
2011	**43**
Total	**$ 2,299**

Inventory Purchase Commitments

At June 30, 2006, the Company had firm commitments to purchase inventory in the amount of $1.9 million during the second and third quarters of its fiscal year ending March 31, 2007.

5. Stock-Based Compensation

The Company adopted SFAS 123R effective April 1, 2006. Prior to April 1, 2006, the Company followed the disclosure-only provisions of SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, and, accordingly, accounted for its stock-based compensation plans using the intrinsic value method under APB 25 and related interpretations.

SFAS 123R requires all stock-based payments, including grants of employee stock options, to be recognized in the statement of operations as an expense, based on their grant date fair values with such fair values amortized over the requisite service period. The Company elected to utilize the modified prospective method for the transition to SFAS 123R. Under the modified prospective method, SFAS 123R applies to all awards granted or modified after the date of adoption. In addition, under the modified prospective method, compensation expense will be recognized for all stock-based compensation awards granted prior to but not yet vested as of April 1, 2006, based on grant-date fair values estimated in accordance with the original provisions of SFAS 123. Accordingly, prior period amounts presented herein have not been restated to reflect the adoption of SFAS 123R.

The fair value concepts were not changed significantly as a result of implementing SFAS 123R; however, in adopting SFAS 123R, companies must choose among alternative valuation models and amortization assumptions. After assessing alternative valuation models and amortization assumptions, the Company continues to use both the Black-Scholes-Merton (BSM) option-pricing formula and straight-line amortization of compensation expense over the requisite service period of stock option grants. The Company will reconsider use of this model if additional information becomes available in the future that indicates another model would be more appropriate, or if grants issued in future periods have characteristics that cannot be reasonably estimated using this model. SFAS 123 did not require the estimation of forfeitures in the calculation of stock compensation expense; however, SFAS 123R does require such estimation and upon adoption of SFAS 123R, the Company changed its methodology to include an estimate of forfeitures. The adoption of SFAS 123R had no effect on cash flows from operating activities because no tax benefits are realized from stock option exercises. The adoption of SFAS 123R also had no effect on cash flows from financing activities.

The following table illustrates the impact of adopting SFAS 123R as if the Company had continued to account for stock-based compensation under APB 25:

	Three Months Ended June 30, 2006	
	SFAS 123R	**APB 25**

	(In thousands, except per share amounts)			
Loss before income taxes	**$**	**(331)**	$	(276)
Net income (loss)	**$**	**279**	$	334
Basic and diluted earnings per common share	**$**	**0.01**	$	0.01

The following table illustrates the effect on net loss and net loss per share for the three months ended June 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company s stock option plans. For purposes of this pro forma disclosure, the fair value of the options was estimated using the BSM option-pricing formula and amortized on a straight-line basis to expense over the options vesting period:

	Three Months Ended June 30, 2005 (In thousands, except per share amounts)
Net loss as reported	$ (726)
Add: Stock-based employee compensation expense included in net loss as reported	265
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(371)
Net loss pro forma	$ (832)
Basic and diluted loss per share as reported	$ (0.03)
Basic and diluted loss per share pro forma	$ (0.03)

The Company has one stock option plan, the 1997 Stock Incentive Plan (the Plan), which provides that options to purchase shares of the Company s unissued common stock may be granted to directors, associates and consultants to the Company at exercise prices which are equal to or greater than the fair market value of the Company s common stock on the date of grant. Options expire ten years after the date of grant or 90 days after termination of employment and generally vest ratably at the rate of 25% on each of the first four anniversaries of the grant date. New shares are issued to satisfy stock option exercises under the Plan.

In connection with the merger of the Company and the Iteris Subsidiary (Note 1), the Company assumed all of the outstanding options under the 1998 Stock Incentive Plan of the Iteris Subsidiary (the 1998 Plan). As of June 30, 2006, options to purchase 5.4 million shares of the Company s common stock were outstanding under the 1998 Plan. No further options may be granted under the 1998 Plan.

Both the Plan and the 1998 Plan (the Plans) provide for accelerated vesting of unvested options in the event of a change in control under certain circumstances. These change in control provisions meet the criteria of a performance condition under SFAS 123R.

A summary of changes in the Plans for the three months ended June 30, 2006 is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Life (In Years)	Aggregate Intrinsic Value
	(In thousands, except per share amounts)			
Options outstanding at March 31, 2006	6,977	$ 1.42	3.97	
Granted	105	$ 2.21	N/A	
Exercised	(140)	$ 1.14	N/A	
Forfeited	(17)	$ 2.74	N/A	
Expired	(22)	$ 2.36	N/A	
Options outstanding at June 30, 2006	6,903	$ 1.43	3.80	$ 8,252
Vested and expected to vest at June 30, 2006	6,766	$ 1.41	3.70	$ 8,202
Options exercisable at June 30, 2006	6,370	$ 1.37	3.44	$ 7,954
Options exercisable pursuant to a change in control at June 30, 2006	6,903	$ 1.43	3.80	$ 8,252

At June 30, 2006, there were 168,000 shares of common stock available for grant under the Plan.

For the three month periods ended June 30, 2006 and 2005, the Company received $168,000 and $87,000, respectively, in cash from the exercise of stock options. Total stock-based compensation expense for the three month period ended June 30, 2006 was $100,000. No income tax benefit was realized from activity in the Plans during the three month periods ended June 30, 2006 and 2005.

At June 30, 2006, there was $788,000 of total unrecognized compensation expense related to unvested stock options. This expense is expected to be recognized over a weighted-average period of approximately 1.6 years.

The fair value of each stock-based award is estimated on the grant date using the BSM option-pricing formula. Expected volatilities are based on the historical volatility of the Company s stock price. The expected life of options granted subsequent to the adoption of SFAS 123R is derived based on the historical life of the Company s options. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury interest rates in effect at the time of grant. The fair value of options granted was estimated using the following weighted-average assumptions:

	Three Months Ended June 30,		
	2006		**2005**
Dividend yield	**0.0**		N/A
Expected life years	**7.0**		N/A
Risk-free interest rate	**5.0**	**%**	N/A
Expected volatility of common stock	**0.89**		N/A

A summary of the grant-date fair value and intrinsic value information is as follows:

	Three Months Ended June 30,			
	2006		**2005**	
	(In thousands, except per share amounts)			
Weighted average grant date fair value per share	**$**	**1.77**	N/A	
Intrinsic value of options exercised	**$**	**163**	$	90
Total fair value of options vested during the period	**$**	**384**	$	473

6. Business Segment Information

The Company currently operates in three reportable segments: Roadway Sensors, Automotive Sensors and Transportation Systems. The Roadway Sensors segment includes the Company s Vantage vehicle detection systems for traffic intersection control and certain highway traffic data collection applications. The Automotive Sensors segment includes AutoVue and is comprised of all activities related to lane departure warning systems for vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies except that certain expenses, such as interest, amortization of certain intangibles and certain corporate expenses are not allocated to the segments. In addition, certain assets including cash and cash equivalents, deferred taxes and certain long-lived and intangible assets are not allocated to the segments. The reportable segments are each managed separately because they manufacture and distribute distinct products or provide services with different processes. All segment revenues are derived from external customers.

The following table sets forth selected unaudited financial information for the Company s reportable segments for the three month periods ended June 30, 2006 and 2005:

	Roadway Sensors	**Automotive Sensors**	**Transportation Systems**	**Total**
	(In thousands)			