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

Form 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2008

OR

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

For the transition period from to

Commission file number: 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.)

1700 Carnegie Avenue, Suite 100

Santa Ana, California

(Address of principal executive office)

92705

(Zip Code)

(949) 270-9400

(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 ☒ No ☐

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

Large accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Accelerated filer ☐

Smaller reporting company ☒

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

Yes ☐ No ☒

As of February 4, 2009, the registrant had 34,186,756 shares of common stock outstanding.

ITERIS, INC.
Quarterly Report on Form 10-Q
For the Three and Nine Months Ended December 31, 2008

Table of Contents

PART I.	FINANCIAL INFORMATION	3
ITEM 1.	FINANCIAL STATEMENTS	3
	CONDENSED CONSOLIDATED BALANCE SHEETS AT DECEMBER 31, 2008 AND MARCH 31, 2008	3
	UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED DECEMBER 31, 2008 AND 2007	4
	UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE NINE MONTHS ENDED DECEMBER 31, 2008 AND 2007	5
	NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS	6
ITEM 2.	MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	16
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	23
ITEM 4T.	CONTROLS AND PROCEDURES	24
PART II.	OTHER INFORMATION	24
ITEM 1.	LEGAL PROCEEDINGS	24
ITEM 1A.	RISK FACTORS	24
ITEM 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	33
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES	33
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	33
ITEM 5.	OTHER INFORMATION	33
ITEM 6.	EXHIBITS	34

Unless otherwise indicated in this report, the “Company,” “we,” “us” and “our” refer to Iteris, Inc. and our wholly-owned subsidiary, Iteris Europe, GmbH.

AutoVue®, Iteris®, Vantage®, VersiCam™, EdgeConnect™, RZ4 Advanced™ and Safety Direct™ 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 par value amounts)

	December 31, 2008 (unaudited)	March 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 5,975	\$ 421
Trade accounts receivable, net of allowance for doubtful accounts of \$782 and \$1,020 at December 31, 2008 and March 31, 2008, respectively	12,850	13,108
Costs and estimated earnings in excess of billings on uncompleted contracts	3,369	5,351
Inventories, net of reserve for inventory obsolescence of \$968 and \$819 at December 31, 2008 and March 31, 2008, respectively	4,997	4,226
Deferred income taxes	841	2,541
Prepaid expenses and other current assets	292	371
Total current assets	28,234	26,018
Property and equipment, net	3,428	3,467
Deferred income taxes	7,807	7,807
Intangible assets, net	147	257
Goodwill	27,774	27,774
Other assets	211	322
Total assets	\$ 67,691	\$ 65,645
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	\$ 3,272	\$ 3,902
Accrued payroll and related expenses	3,291	3,825
Accrued liabilities	1,873	1,973
Billings in excess of costs and estimated earnings on uncompleted contracts	1,790	1,126
Current portion of long-term debt	2,191	244
Total current liabilities	12,417	11,070
Deferred rent	1,752	1,956
Unrecognized tax benefits	1,098	1,381
Other non-current liabilities	37	461
Long-term debt	5,114	7,566
Total liabilities	20,418	22,434
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$1.00 par value, 2,000 shares authorized, none issued and outstanding at December 31, 2008 and March 31, 2008	—	—
Common stock, \$0.10 par value, 70,000 shares authorized, 34,182 and 33,420 shares issued and outstanding at December 31, 2008 and March 31, 2008, respectively	3,418	3,342
Additional paid-in capital	136,887	135,516
Common stock held in trust, 24 and 167 shares at December 31, 2008 and March 31, 2008, respectively	(31)	(202)
Accumulated deficit	(93,025)	(95,499)
Accumulated other comprehensive income	24	54
Total stockholders' equity	47,273	43,211
Total liabilities and stockholders' equity	\$ 67,691	\$ 65,645

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 December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
Net sales and contract revenues:				
Net sales	\$ 9,083	\$ 9,176	\$ 30,687	\$ 30,215
Contract revenues	7,379	6,187	22,283	17,881
Total net sales and contract revenues	16,462	15,363	52,970	48,096
Costs of net sales and contract revenues:				
Cost of net sales(a)	4,890	4,631	16,043	15,302
Cost of contract revenues(a)	5,068	4,232	14,796	11,938
Gross profit	6,504	6,500	22,131	20,856
Operating expenses:				
Selling, general and administrative(a)	4,385	4,331	14,193	13,119
Research and development(a)	848	1,002	3,180	2,623
Amortization of intangible assets	37	37	110	110
Total operating expenses	5,270	5,370	17,483	15,852
Operating income	1,234	1,130	4,648	5,004
Non-operating income (expense):				
Other income, net	63	(3)	90	41
Interest expense, net	(141)	(314)	(537)	(1,046)
Income before income taxes	1,156	813	4,201	3,999
Income tax benefit (provision)	(415)	141	(1,727)	221
Net income	\$ 741	\$ 954	\$ 2,474	\$ 4,220
Earnings per share:				
Basic	\$ 0.02	\$ 0.03	\$ 0.07	\$ 0.13
Diluted	\$ 0.02	\$ 0.03	\$ 0.07	\$ 0.12
Weighted average shares outstanding:				
Basic	34,120	32,914	33,895	32,568
Diluted	34,358	35,256	34,752	34,674
(a) Includes stock-based compensation expense as follows:				
Cost of net sales	\$ 2	\$ 1	\$ 7	\$ 3
Cost of contract revenues	10	3	30	9
Selling, general and administrative	75	77	228	190
Research and development	5	1	15	5
Total	\$ 92	\$ 82	\$ 280	\$ 207

See accompanying notes to unaudited condensed consolidated financial statements.

ITERIS, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended December 31,	
	2008	2007
Cash flows from operating activities		
Net income	\$ 2,474	\$ 4,220
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in deferred tax assets	1,700	(229)
Depreciation and amortization of property and equipment	755	443
Stock-based compensation expense	280	207
Amortization of debt discount	166	155
Amortization of intangible assets	110	110
Amortization of deferred financing costs	110	104
Amortization of deferred gain on sale—leaseback transaction	—	(165)
Changes in operating assets and liabilities:		
Accounts receivable	258	(1,114)
Net costs and estimated earnings in excess of billings	2,646	(1,108)
Inventories	(771)	1,979
Prepaid expenses and other assets	80	(166)
Accounts payable and accrued liabilities	(1,778)	928
Net cash provided by operating activities	<u>6,030</u>	<u>5,364</u>
Cash flows from investing activities		
Purchases of property and equipment	(716)	(455)
Cash flows from financing activities		
Proceeds from stock option and warrant exercises	911	1,325
Borrowings on long-term debt	5,073	—
Payments on long-term debt	(5,744)	(1,727)
Net payments on line of credit	—	(3,816)
Change in checks drawn in excess of available bank balances	—	(47)
Net cash provided by (used in) financing activities	<u>240</u>	<u>(4,265)</u>
Increase in cash	5,554	644
Cash at beginning of period	421	35
Cash at end of period	<u>\$ 5,975</u>	<u>\$ 679</u>
Supplemental cash flow information:		
Cash paid during the period:		
Interest	\$ 435	\$ 825
Income taxes	404	48
Supplemental schedule of non-cash investing and financing activities:		
Fair value of common stock issued in settlement of liabilities	\$ 427	\$ 350
Conversion of redeemable common stock to common stock	—	3,414
Lease incentives in connection with new headquarters lease	—	1,772
Write-off of notes receivable from employees	—	(5)

See accompanying notes to unaudited condensed consolidated financial statements.

ITERIS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Iteris, Inc. is a leader in the traffic management market focused on the development and application of advanced technologies that reduce traffic congestion and improve the safety of surface transportation systems infrastructure. By combining outdoor image processing, traffic engineering and information technology, the Company offers a broad range of Intelligent Transportation Systems ("ITS") and driver safety solutions to customers worldwide. As an added benefit, the Company's products and services minimize the environmental impact of traffic congestion. The Company was originally incorporated in Delaware in 1987.

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 December 31, 2008, the consolidated results of operations for the three and nine months ended December 31, 2008 and 2007, and the consolidated cash flows for the nine months ended December 31, 2008 and 2007. 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 and nine months ended December 31, 2008 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, 2008, which was filed with the SEC on June 12, 2008.

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.

Reclassifications

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

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.

[Table of Contents](#)

In addition to product and contract revenue, the Company derives revenue from the provision of specific non-recurring contract engineering services and royalties. 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. Non-recurring 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.

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 generally depreciated using the straight-line method 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.

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 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 Company determines the fair value of reporting units 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.

Stock-Based Compensation

Effective April 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (“SFAS 123R”), which 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 use the modified prospective transition method for 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 is 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 No. 123, *Accounting for Stock-Based Compensation*.

The fair value of the Company’s common stock option awards is estimated on the grant date using the Black-Scholes-Merton (“BSM”) option-pricing formula. Expected volatility is 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 interest 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.

Research and Development Expenditures

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

Shipping and Handling Costs

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

Sales Taxes

Sales taxes are presented on a net basis (excluded from net sales and contract revenues) in the unaudited condensed consolidated statements of operations.

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.

Other Comprehensive Income

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

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 157, *Fair Value Measurements* (“SFAS 157”), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those

[Table of Contents](#)

fiscal years. In February 2008, the FASB issued FASB Staff Position (“FSP”) 157-2, *Effective Date of FASB Statement No. 157* (“FSP 157-2”), which delays the effective date of SFAS 157 for non-financial assets and liabilities to fiscal years beginning after November 15, 2008. Generally, SFAS 157 will be applied prospectively. With respect to financial assets and liabilities, the Company adopted SFAS 157 in the first quarter of fiscal 2009. There was no material impact on the consolidated financial statements. The Company is currently evaluating the impact of SFAS 157 and FSP 157-2 with respect to its non-financial assets and liabilities and expects to adopt SFAS 157 and FSP 157-2 with respect to these assets and liabilities in the first quarter of its fiscal year ending March 31, 2010.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115* (“SFAS 159”). SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement of certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted under special rules. The adoption of SFAS 159 did not have a material impact on the consolidated financial statements of the Company.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (“SFAS 141R”). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. The nature and magnitude of the specific effects of adopting SFAS 141R will depend upon the nature, terms and size of any acquisitions the Company may consummate after the effective date of the Company’s adoption of SFAS 141R (April 1, 2009).

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (“SFAS 162”). SFAS 162 identifies the sources of accounting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. GAAP. SFAS 162 is effective 60 days following the SEC approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The Company currently adheres to the hierarchy of U.S. GAAP as presented in SFAS 162, and adoption is not expected to have a material impact on its consolidated financial statements.

In June 2008, the FASB issued Emerging Issues Task Force (“EITF”) Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock* (“EITF 07-5”). EITF 07-5 clarifies how to determine whether certain instruments or features were indexed to an entity’s own stock under EITF Issue No. 01-6, *The Meaning of “Indexed to a Company’s Own Stock,”* (“EITF 01-6”) and provides guidance to determine what accounting literature may apply to a particular equity linked instrument or feature. EITF 07-5 will become effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and must be applied to all instruments outstanding on the date of adoption. The Company is currently evaluating the impact of EITF 07-5, and has not yet determined the effect, if any, of its adoption on the Company’s consolidated financial statements.

2. Supplemental Financial Information

Inventories

The following table presents details of the Company’s inventories:

	December 31, 2008	March 31, 2008
	(In thousands)	
Materials and supplies	\$ 4,152	\$ 3,031
Work in process	16	345
Finished goods	829	850
	<u>\$ 4,997</u>	<u>\$ 4,226</u>

Intangible Assets

	December 31, 2008		March 31, 2008	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
	(In thousands)			
Developed technology	\$ 495	\$ (457)	\$ 495	\$ (381)
Patents	317	(208)	317	(174)
Total	<u>\$ 812</u>	<u>\$ (665)</u>	<u>\$ 812</u>	<u>\$ (555)</u>

[Table of Contents](#)

Amortization expense for intangible assets subject to amortization was \$37,000 and \$110,000 for the three and nine months ended December 31, 2008, respectively, and \$37,000 and \$110,000 for the three and nine months ended December 31, 2007, respectively. Future estimated amortization expense for the remainder of the current fiscal year and the next three fiscal years is as follows:

Fiscal Year Ending March 31:

(In thousands)

Remainder of 2009	\$	37
2010		58
2011		46
2012		6
	\$	<u>147</u>

Warranty Reserve Activity

The following table presents activity in accrued warranty obligations:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
	(In thousands)			
Balance at beginning of period	\$ 557	\$ 489	\$ 494	\$ 520
Additions charged to cost of sales	74	109	258	253
Warranty claims	(75)	(74)	(196)	(249)
Balance at end of period	<u>\$ 556</u>	<u>\$ 524</u>	<u>\$ 556</u>	<u>\$ 524</u>

Earnings Per Share

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
	(In thousands, except per share amounts)			
Numerator:				
Net income	<u>\$ 741</u>	<u>\$ 954</u>	<u>\$ 2,474</u>	<u>\$ 4,220</u>
Denominator:				
Weighted average common shares used in basic computation	34,120	32,914	33,895	32,568
Dilutive stock options	238	2,329	853	2,086
Dilutive warrants	—	13	4	20
Weighted average common shares used in dilutive computation	<u>34,358</u>	<u>35,256</u>	<u>34,752</u>	<u>34,674</u>
Earnings per share:				
Basic	<u>\$ 0.02</u>	<u>\$ 0.03</u>	<u>\$ 0.07</u>	<u>\$ 0.13</u>
Diluted	<u>\$ 0.02</u>	<u>\$ 0.03</u>	<u>\$ 0.07</u>	<u>\$ 0.12</u>

The following shares were excluded from the computation of diluted earnings per share as their effect would have been anti-dilutive:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
	(In thousands)			
Stock options	2,184	355	1,245	552
Warrants	1,165	1,150	1,155	1,177
Convertible debentures	623	2,729	1,639	2,729

3. Revolving Line of Credit and Long-Term Debt

Revolving Line of Credit

Prior to October 16, 2008, the Company had a credit facility with a bank that provided for line of credit borrowings of up to \$10.0 million. Under this credit facility, the Company could borrow against its eligible accounts receivable and eligible inventory, as defined in the credit agreement. Interest on borrowed amounts under the line of credit was payable monthly at the current stated prime rate plus 1.00%. Additionally, the Company was obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeded the average daily principal balance during the preceding month. The credit facility required \$2,000 in monthly collateral management fees and included an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. The credit facility was secured by substantially all of the assets of the Company. This credit facility expired on October 15, 2008.

Effective October 16, 2008, the Company entered into a new \$19.5 million credit facility with a different bank which replaced the Company's existing credit facility. This new credit facility provides for a two-year revolving line of credit with borrowings of up to \$12.0 million and a \$7.5 million 48-month term note (discussed below). Interest on borrowed amounts under the revolving line of credit will be payable monthly at a rate equal to the current stated prime rate up to the current stated prime rate plus 0.50%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility (3.75% at December 31, 2008). The Company is obligated to pay an unused line fee of 0.25% per annum applied to the average unused portion of the \$12.0 million revolving line of credit during the preceding month. The revolving line of credit does not contain any early termination fees and is secured by substantially all of the assets of the Company. As of December 31, 2008, no amounts were borrowed under the revolving line of credit portion of the facility. As part of this new credit facility, the Company may also borrow up to \$7.5 million in the form of a 48-month term note to retire its convertible debentures as discussed below under "Long-Term Debt — Bank Term Notes".

Long-Term Debt

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

	December 31, 2008	March 31, 2008
	(In thousands)	
Convertible debentures, net	\$ 2,232	\$ 7,566
Bank term notes	5,073	210
Other	—	34
	7,305	7,810
Less current portion	(2,191)	(244)
	<u>\$ 5,114</u>	<u>\$ 7,566</u>

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 18, 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, 2008 until the maturity date, the Company may redeem the debentures at 110% of the principal amount. As of December 31, 2008, \$250,000 of debentures had been converted into 69,252 shares of the Company's common stock.

[Table of Contents](#)

Additionally, as of December 31, 2008, the Company had retired \$7.6 million of its outstanding debentures, at the holders' request, using \$2.1 million in cash and \$5.07 million financed under the Company's new bank term note, which is described below under the caption "Bank Term Notes." In January 2009, the Company paid \$1.47 million to retire an additional \$1.5 million of debentures, at the holders' request, leaving \$750,000 of debentures outstanding. The \$1.47 million was also financed under the Company's new bank term note. In accordance with SFAS No. 6, *Classifications of Short-Term Obligations Expected to Be Refinanced*, the Company has classified the long-term portion of the debentures financed under the new term note subsequent to December 31, 2008 as long-term debt in the accompanying condensed consolidated balance sheet.

Bank Term Notes. In October 2004, the Company entered into a \$5.0 million term note payable with a bank. The note was due on May 27, 2008, and provided for monthly principal payments of approximately \$104,000. The final payment against this term note was made in June 2008.

Effective October 16, 2008, the Company entered into a new \$19.5 million credit facility with a different bank, as described above. Under this new credit facility, the Company may borrow up to \$7.5 million in the form of a 48-month term note to retire all outstanding convertible debentures. Principal payments under this term note are required to be repaid in 48 monthly installments commencing on June 1, 2009. Interest on the term note will be payable monthly at a rate equal to the current stated prime rate plus 0.50% up to the current stated prime rate plus 1.00%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility (4.25% at December 31, 2008). The Company paid an upfront loan commitment fee of \$28,000 for the term note. The term note contains no early termination fees and, along with the new revolving line of credit under the same credit agreement (above), is secured by substantially all of the assets of the Company. As of December 31, 2008, \$5.07 million had been borrowed against this term note to repay debentures. In January 2009, an additional \$1.47 million was borrowed for the same purpose; increasing the total amount borrowed under the term note to \$6.5 million as of February 6, 2009.

On February 4, 2009 the Company entered into an Amended and Restated Loan and Security Agreement with its current senior lender which supersedes the agreements entered into on October 16, 2008 in their entirety. The October 16, 2008 documents were amended and restated to clarify the meaning of certain ambiguities and remove non-applicable language. No modifications were made to any significant provisions related to the overall amount of the credit facility, interest rate calculations, or any financial or non-financial covenant.

Scheduled aggregate maturities of long-term debt principal as of December 31, 2008, were as follows:

Fiscal Year Ending March 31,	
(In thousands)	
2009	\$ —
2010	2,620
2011	2,144
2012	2,144
2013	415
Thereafter	—
	<u>7,323</u>
Less: unamortized debt discount	(18)
	<u><u>\$ 7,305</u></u>

4. Commitments and Contingencies

Litigation and Other Contingencies

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 such 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, 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 December 31, 2008 were as follows:

Fiscal Year Ending March 31,
(In thousands)

Remainder of 2009	\$	812
2010		1,661
2011		1,444
2012		1,365
2013		1,380
Thereafter		2,460
Total	\$	9,122

The Company previously subleased office space to MAXxess Systems, Inc. ("MAXxess"), a former subsidiary of the Company that was sold by the Company in September 2003 and is currently owned by an investor group that includes four of the Company's directors, one of whom is the Chief Executive Officer of MAXxess. At December 31, 2008, MAXxess owed the Company an aggregate of \$274,000 related to this sublease, which terminated in September 2007, and certain related ancillary services that were previously provided by the Company to MAXxess. Although the Company has fully reserved for amounts owed to it by MAXxess under the terms of this sublease, the Company plans to continue to pursue full payment of any and all amounts due from MAXxess, but cannot assure that MAXxess will be able to make such payments.

Inventory Purchase Commitments

At December 31, 2008, the Company had firm commitments to purchase inventory in the amount of approximately \$2.5 million during the next three fiscal quarters.

5. Stock-Based Compensation

Under the Company's 2007 Omnibus Incentive Plan (the "2007 Plan"), options to purchase shares of the Company's unissued common stock may be granted to the Company's employees, officers, consultants and directors 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 no more than ten years after the date of grant and generally vest at the rate of 25% on each of the first four anniversaries of the grant date. The 2007 Plan also allows for the issuance of stock appreciation rights, restricted stock, restricted stock units and other stock-based awards. New shares are issued to satisfy stock option exercises and share issuances under the 2007 Plan. As of December 31, 2008, options to purchase an aggregate of 404,000 shares of common stock were outstanding under the 2007 Plan.

The Company's 1997 Stock Incentive Plan (the "1997 Plan") terminated in September 2007; however, all stock options outstanding under the 1997 Plan will remain outstanding pursuant to the terms of such stock options. As of December 31, 2008, options to purchase approximately 1.3 million shares of the Company's common stock were outstanding under the 1997 Plan.

In connection with the October 2004 merger of the Company and its previously majority-owned subsidiary, Iteris Inc. (the "Iteris Subsidiary"), the Company assumed the 1998 Stock Incentive Plan of the Iteris Subsidiary (the "1998 Plan") and all outstanding options granted thereunder. As of December 31, 2008, options to purchase approximately 1.8 million shares of the Company's common stock were outstanding under the 1998 Plan. The 1998 Plan has been terminated and no further options may be granted under the 1998 Plan.

Certain options granted under the 2007 Plan, the 1997 Plan and the 1998 Plan (collectively, 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.

[Table of Contents](#)

A summary of activity in the Plans for the nine months ended December 31, 2008 is as follows:

Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
(In thousands, except number of years)			
Options outstanding at March 31, 2008	4,524	\$ 1.83	3.7
Granted	30	2.10	N/A
Exercised	(762)	1.20	N/A
Forfeited	(18)	2.59	N/A
Expired	(303)	2.53	N/A
Options outstanding at December 31, 2008	3,471	\$ 1.91	4.1
Vested and expected to vest at December 31, 2008	3,381	\$ 1.90	4.0
Options exercisable at December 31, 2008	2,949	\$ 1.82	3.4
Options exercisable at December 31, 2008 pursuant to a change-in-control	3,471	\$ 1.91	4.1
			\$ 1,781
			\$ 1,781
			\$ 1,781
			\$ 1,781

At December 31, 2008, there were 446,000 shares of common stock available for grant under the 2007 Plan.

For the nine months ended December 31, 2008 and 2007, the Company received \$911,000 and \$1.2 million, respectively, in cash from the exercise of stock options. Total stock-based compensation expense was \$92,000 and \$280,000 for the three and nine months ended December 31, 2008, respectively, and \$82,000 and \$207,000 for the three and nine months ended December 31, 2007, respectively. No income tax benefit was realized from activity in the Plans during the nine months ended December 31, 2008 and 2007.

At December 31, 2008, there was \$960,000 of total unrecognized compensation expense related to unvested stock options. This expense is expected to be recognized over a weighted-average period of approximately 3.1 years.

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
(In thousands, except per share amounts)				
Weighted average grant date fair value per share	\$ —	\$ 1.82	\$ 1.50	\$ 1.81
Intrinsic value of options exercised	\$ 16	\$ 650	\$ 770	\$ 2,297

6. Business Segment Information

The Company currently operates in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes the Company's Vantage and VersiCam vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. The Vehicle Sensors segment includes AutoVue and is comprised of all activities related to 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. 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.

[Table of Contents](#)

The following table sets forth selected unaudited financial information for the Company's reportable segments for the three and nine months ended December 31, 2008 and 2007:

	Roadway Sensors	Vehicle Sensors	Transportation Systems	Total
(In thousands)				
Three Months Ended December 31, 2008				
Product revenue	\$ 6,291	\$ 2,477	\$ —	\$ 8,768
Service and other revenue	—	315	7,379	7,694
Stock-based compensation	8	12	13	33
Depreciation and amortization	48	32	65	145
Segment income	773	105	425	1,303
Three Months Ended December 31, 2007				
Product revenue	\$ 6,432	\$ 2,281	\$ —	\$ 8,713
Service and other revenue	—	463	6,187	6,650
Stock-based compensation	3	10	6	19
Depreciation and amortization	26	32	39	97
Segment income	929	167	449	1,545
Nine Months Ended December 31, 2008				
Product revenue	\$ 21,334	\$ 8,380	\$ —	\$ 29,714
Service and other revenue	—	973	22,283	23,256
Stock-based compensation	24	36	39	99
Depreciation and amortization	144	105	185	434
Segment income	2,887	552	1,569	5,008
Nine Months Ended December 31, 2007				
Product revenue	\$ 21,273	\$ 7,630	\$ —	\$ 28,903
Service and other revenue	—	1,312	17,881	19,193
Stock-based compensation	13	34	19	66
Depreciation and amortization	79	98	105	282
Segment income	3,725	439	1,426	5,590

The following table reconciles segment income to consolidated income before income taxes:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
(In thousands)				
Total income for reportable segments	\$ 1,303	\$ 1,545	\$ 5,008	\$ 5,590
Unallocated amounts:				
Corporate expenses	(69)	(415)	(360)	(586)
Other income, net	63	(3)	90	41
Interest expense, net	(141)	(314)	(537)	(1,046)
Income before income taxes	\$ 1,156	\$ 813	\$ 4,201	\$ 3,999

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

This report, including the following discussion and analysis, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that are based on our current expectations, estimates and projections about our business and our industry, and reflect management's beliefs and certain assumptions made by us based upon information available to us as of the date of this report. When used in this report and the information incorporated herein by reference, the words "expect(s)," "feel(s)," "believe(s)," "should," "will," "may," "anticipate(s)," "estimate(s)" and similar expressions or variations of these words are intended to identify forward-looking statements. These forward-looking statements include but are not limited to statements regarding our anticipated sales, revenue, expenses, profits, capital needs, competition, development plans, backlog and manufacturing capabilities, the applications for and acceptance of our products and services, and the status of our facilities and product development. These statements are not guarantees of future performance and are subject to certain risks and uncertainties that could cause our actual results to differ materially from those projected. You should not place undue reliance on these forward-looking statements that speak only as of the date hereof. We undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. We encourage you to carefully review and consider the various disclosures made by us which describe certain factors which could affect our business, including in "Risk Factors" set forth in Part II, Item 1A of this report, before deciding to invest in our company or to maintain or increase your investment. We undertake no obligation to revise or update publicly any forward-looking statement for any reason.

Overview

We are a leader in the traffic management market focused on the development and application of advanced technologies that reduce traffic congestion and improve the safety of surface transportation systems infrastructure. As an added benefit, our products and services minimize the environmental impact of traffic congestion. By combining outdoor image processing, traffic engineering and information technology, we offer a broad range of Intelligent Transportation Systems and driver safety solutions to customers worldwide. the environmental

We currently operate in three reportable segments: Roadway Sensors, Vehicle Sensors, and Transportation Systems. The Roadway Sensors segment includes our Vantage and VersiCam vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. The Vehicle Sensors segment includes our AutoVue Lane Departure Warning ("LDW") system and is comprised of all activities related to 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.

Our Vantage product line uses advanced image processing technology to capture and analyze video images through sophisticated algorithms, enabling vehicle detection and transmission of both video images and data using a wide range of communication technologies. Vantage video detection systems detect vehicle presence, count, speed, occupancy, and other traffic data used in traffic management systems. This gives traffic managers the ability to mitigate roadway congestion by modifying traffic signal timing or detecting incidents quickly. VersiCam, our integrated camera and processor video detection system, which was introduced in April of 2008, is a cost-efficient video detection system for smaller intersections that require only a few detection points. Vantage video detection systems have been deployed by hundreds of agencies and are currently sold through a network of independent dealers in the United States, Asia, Latin America, Europe and the Middle East.

Our Vehicle Sensors segment addresses the leading cause of roadway fatalities: rear-end, lane change, and roadway departure accidents. According to the National Highway Traffic Safety Administration, these three crash types result in about 27,500 of the U.S.'s 42,000 annual traffic fatalities and contribute to a considerable economic loss due to injuries, property damage, and decreased productivity.

We developed the world's first production LDW system and offer a proven system that is available as an OEM option in passenger cars and as an OEM and aftermarket option on heavy trucks worldwide. The AutoVue LDW system utilizes video detection images to detect when a vehicle begins to drift toward an unintended lane change. When this occurs, the unit automatically emits a distinctive rumble strip or other audible warning sound, alerting the driver to make a correction. To date, we have sold approximately 67,000 LDW systems into the heavy truck market in Europe, North America and Asia. Our LDW systems are currently qualified as an option on certain heavy trucks, including Mercedes-Benz, MAN, Iveco, DAF, Scania, Freightliner and FUSO, as well as Neoplan and MAN luxury bus and coach lines. In North America, our LDW systems are sold primarily to truck fleets, and to date, 71 U.S. heavy truck fleets have selected our LDW systems, with a combined fleet size estimated at 56,000 vehicles. Additionally, we have licensed our LDW technology to our strategic partner, Valeo Schalter and Sensuren GmbH, an independent automotive supplier ("Valeo"), resulting in sales to date of approximately 69,000 LDW systems for passenger cars.

[Table of Contents](#)

In addition to our LDW systems, we have expanded our Vehicle Sensors portfolio in August 2008 with newly developed technologies such as radar based Forward Collision Warning ("FCW") and Blind Spot Warning ("BSW") systems for the North American truck market. We also introduced Safety Direct in March 2008, which is a system that reports real-time driver performance data captured by our LDW system and that has the ability to relay this information directly to fleet operators through integration with the truck's existing fleet communications system. We offer the FCW and BSW features through the resale of Delphi's radar based systems, for which we are the exclusive North American dealer, while Safety-Direct was internally developed. These new products, together with the AutoVue LDW system, combine to create a broad suite of active safety driver assistance features that help to reduce the number of motor vehicle crashes and the severity of crash-related injuries.

Our Transportation Systems segment includes transportation engineering and consulting services focused on the planning, design, development and implementation of software-based systems that integrate sensors, video surveillance, computers, and advanced communications equipment to enable public agencies to monitor, control, and direct traffic flow, assist in the quick dispatch of emergency crews and distribute real-time information about traffic conditions. Our services include planning, design, and implementation of surface transportation infrastructure systems. We perform analysis and study goods movement, commercial vehicle operations, travel demand forecasting, and systems engineering, and identify mitigation measures to reduce traffic congestion. These services and systems are primarily sold to local, state, and national transportation agencies in the United States. Our transportation management systems business is largely dependent upon governmental funding and budgetary issues. The Federal Highway Bill that was passed in August 2005 provided for a significant increase in transportation funding. We believe the recent expansion of our transportation management systems business was due in part to the passage of the Federal Highway Bill, combined with increased transportation funds available at state and local agencies throughout the country. The 2005 Federal Highway Bill is set to expire in September 2009. At this point in time, the impact on future contract revenues as a result of the recently introduced federal stimulus package and any potential delays in the passage of future transportation bills cannot be determined.

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our unaudited condensed consolidated financial statements included herein, which have been prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related 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. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the collectibility of accounts receivable, the valuation of inventories, the recoverability of long-lived assets and goodwill, the realizability of deferred tax assets, accounting for stock-based compensation, the valuation of equity instruments, warranty reserves and other contingencies. We base these estimates on our historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. These estimates and assumptions by their nature involve risks and uncertainties, and may prove to be inaccurate. In the event that any of our estimates or assumptions are inaccurate in any material respect, it could have a material adverse effect on our reported assets and liabilities at the date of the financial statements and our reported revenues and expenses during the reporting period.

The accounting policies that affect our more significant judgments and estimates used in the preparation of our unaudited condensed consolidated financial statements are those relating to revenue recognition, accounts receivable, inventory, goodwill, warranty, income taxes, and stock-based compensation. These policies are described in further detail in our Annual Report on Form 10-K for the fiscal year ended March 31, 2008. There have been no significant changes in our critical accounting policies and estimates during the nine months ended December 31, 2008 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended March 31, 2008.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 157, *Fair Value Measurements*, or SFAS 157, which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim

[Table of Contents](#)

periods within those fiscal years. In February 2008, the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157*, or FSP 157-2, which delays the effective date of SFAS 157 for non-financial assets and liabilities to fiscal years beginning after November 15, 2008. Generally, SFAS 157 will be applied prospectively. With respect to financial assets and liabilities, we adopted SFAS 157 in the first quarter of fiscal 2009. There was no material impact on our consolidated financial statements. We are currently evaluating the impact of SFAS 157 and FSP 157-2 with respect to our non-financial assets and liabilities and expect to adopt SFAS 157 and FSP 157-2 with respect to these assets and liabilities in the first quarter of our fiscal year ending March 31, 2010.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115*. This statement allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement of certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. This statement is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted under special rules. The adoption of this statement did not have a material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*, or SFAS 141R. SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. The nature and magnitude of the specific effects of adopting SFAS 141R will depend upon the nature, terms and size of any acquisitions we may consummate after the effective date of the Company's adoption on April 1, 2009.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, or SFAS 162. SFAS 162 identifies the sources of accounting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. GAAP. SFAS 162 is effective 60 days following the Securities and Exchange Commission approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. We currently adhere to the hierarchy of U.S. GAAP as presented in SFAS 162, and adoption is not expected to have a material impact on our consolidated financial statements.

In June 2008, the FASB issued Emerging Issues Task Force Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock*, or EITF 07-5. EITF 07-5 clarifies how to determine whether certain instruments or features were indexed to an entity's own stock under EITF Issue No. 01-6, *The Meaning of "Indexed to a Company's Own Stock,"* and provides guidance to determine what accounting literature may apply to a particular equity linked instrument or feature. EITF 07-5 will become effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and must be applied to all instruments outstanding on the date of adoption. We are currently evaluating the impact of EITF 07-5, and have not yet determined the effect, if any, of its adoption on our consolidated financial statements.

Results of Operations

The following table sets forth certain statement of operations data as a percentage of total net sales and contract revenues for the periods indicated.

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
Net sales and contract revenues:				
Net sales	55.2%	59.7%	57.9%	62.8%
Contract revenues	44.8	40.3	42.1	37.2
Total net sales and contract revenues	100.0%	100.0%	100.0%	100.0%
Costs of net sales and contract revenues:				
Cost of net sales	29.7	30.2	30.3	31.8
Cost of contract revenues	30.8	27.5	27.9	24.8
Gross profit	39.5	42.3	41.8	43.4
Operating expenses:				
Selling, general and administrative	26.7	28.3	26.8	27.3
Research and development	5.1	6.5	6.0	5.5
Amortization of intangible assets	0.2	0.2	0.2	0.2
Total operating expenses	32.0	35.0	33.0	33.0
Operating income	7.5	7.3	8.8	10.4
Non-operating income (expense):				
Other income, net	0.4	(0.0)	0.2	0.1
Interest expense, net	(0.9)	(2.0)	(1.0)	(2.2)
Income before income taxes	7.0	5.3	8.0	8.3
Income tax benefit (provision)	(2.5)	0.9	(3.3)	0.5
Net income	4.5%	6.2%	4.7%	8.8%

Analysis of Quarterly Results of Operations

Net Sales and Contract Revenues. Net sales are comprised of Roadway Sensors sales, which are derived from sales of our Vantage and VersiCam video detection systems, and Vehicle Sensor sales, which are derived from sales of our active vehicle safety products, contract engineering revenue from Valeo, and royalty revenue generated from sales of LDW systems, by our partner Valeo, to the passenger car market. Contract revenues consist entirely of Transportation Systems revenues, which are generated from systems integration and ITS consulting services with federal, state, county, and municipal agencies. We currently have a relatively diverse customer base with no customer representing greater than 10% of total net sales and contract revenues in the three and nine months ended December 31, 2008, respectively.

Total net sales and contract revenues increased 7.2% to \$16.5 million and 10.1% to \$53.0 million for the three and nine months ended December 31, 2008, respectively, compared to \$15.4 million and \$48.1 million in the corresponding periods of the prior fiscal year. The increase was primarily driven by higher contract revenues partially offset by a decrease in net Roadway Sensor revenues, as discussed below.

Net sales decreased 1.0% to \$9.1 million and increased 1.6% to \$30.7 million for the three and nine months ended December 31, 2008, respectively, compared to \$9.2 million and \$30.2 million in the corresponding periods of the prior fiscal year.

Roadway Sensors net sales decreased 2.2% to \$6.3 million compared to \$6.4 million for the three months ended December 31, 2008 and were relatively flat for the nine months ended December 31, 2008 compared to the corresponding periods of the prior fiscal year mainly due to reduced and delayed spending on infrastructure projects as a result of the decline in commercial and residential construction, as well as local government budgetary pressures. We expect these factors may continue to adversely impact our Roadway Sensors net sales for at least the next few fiscal quarters.

Vehicle Sensors net sales increased 1.7% to \$2.8 million and 4.6% to \$9.4 million for the three and nine months ended December 31, 2008, respectively, versus \$2.7 million and \$8.9 million in the corresponding periods of the prior fiscal year. This increase was primarily a result of a slight increase in unit sales in the North American truck market, which was offset in part by lower unit sales of our LDW systems to European and Asian OEMs. Sales of

[Table of Contents](#)

LDW systems to the heavy truck market increased 8.6% to \$2.5 million and 9.8% to \$8.4 million for the three and nine month periods ended December 31, 2008, when compared to the corresponding periods in the prior fiscal year. We may continue to experience either relatively flat or decreased sales to the North American heavy truck market and in sales to our European and Asian OEMs customers in our next few fiscal quarters as a result of an overall decline in new truck sales in the U.S, Europe and Asia, the general slowdown in the U.S. credit markets and weakness in overall global economy. Also included in Vehicle Sensors net sales are revenues from contract engineering services and royalty revenues in the passenger car market that are derived from our strategic relationship with Valeo, which aggregated \$315,000 and \$973,000 for the three and nine months ended December 31, 2008, respectively, compared to \$463,000 and \$1.3 million in the corresponding periods of the prior fiscal year. We expect contract engineering revenues to remain relatively stable for the foreseeable future.

Contract revenues increased 19.3% to \$7.4 million and 24.6% to \$22.3 million for the three and nine months ended December 31, 2008, respectively, compared to \$6.2 million and \$17.9 million in the corresponding periods of the prior fiscal year. This increase was largely a result of increased sales and marketing activity across the country. In response to this growth, we have slightly increased our Transportation Systems staff in the nine months ended December 31, 2008. We believe the ability of our Transportation Systems business to grow and successfully win and service new contracts will be highly dependent upon our continued success in recruiting and retaining qualified personnel. We anticipate that our contract revenues will continue to increase for the balance of fiscal 2009, largely as a result of significant new contracts awarded to us during the first six months of fiscal 2009. All of our contract revenues are derived from work performed in North America under a broad range of fixed price and cost plus fixed fee contracts.

It is conceivable that, as a result of the continued deterioration of economic conditions in the U.S., the decline in residential and commercial construction, the tightening of the credit markets, and the expiration of the 2005 Federal Highway Bill in September of 2009, government funding for certain traffic initiatives and roadway improvement projects could be delayed or diverted to focus on other budgetary needs. Should this occur, it is likely that future domestic Roadway Sensors net sales and Transportation System contract revenues and backlog would be adversely affected.

Gross Profit. Total gross profit was flat for the three months ended December 31, 2008 and increased 6.1% to \$22.1 million for the nine months ended December 31, 2008, respectively, as compared to \$6.5 million and \$20.9 million in the corresponding periods of the prior fiscal year. Total gross profit as a percent of net sales and contract revenues decreased to 39.5% and 41.8% for the three and nine months ended December 31, 2008, respectively, as compared to 42.3% and 43.4% in the corresponding periods of the prior fiscal year.

Gross profit as a percent of net sales was 46.2% and 47.7% for the three and nine months ended December 31, 2008, respectively, compared to 49.5% and 49.4% in the corresponding periods of the prior fiscal year. This decrease in gross profit as a percent of net sales was a result of decreased gross profit in both Roadway Sensors and Vehicle Sensors and was primarily driven by customer mix. Roadway Sensors net sales have been weighted more toward dealer than direct sales in fiscal 2009 while Vehicle Sensors net sales have been weighted more toward OEMs than after-market sales in fiscal 2009. We generally enjoy higher gross margins on direct and OEM sales when compared to dealer and aftermarket sales. We anticipate that this mix will remain relatively constant for the remainder of fiscal 2009. Gross profit as a percent of net sales generally fluctuates in any specific quarter based on customer mix. Gross profit as a percent of net sales has fluctuated over the last eleven quarters from a high of 50.0% in the first quarter of fiscal 2009 to a low of 43.2% reported in the second quarter of fiscal 2007.

Gross profit as a percent of contract revenues was 31.3% and 33.6% for the three and nine months ended December 31, 2008, respectively, compared to 31.6% and 33.2% in the corresponding periods of the prior fiscal year. We recognize contract revenues and related gross profit using percentage of completion contract accounting and the underlying mix of contract activity affects the related gross profit recognized in any given period. The slight change in gross profit as a percent of contract revenues for the three and nine months ended December 31, 2008 reflects a contract mix weighted more toward contract revenues, which generally carry lower margins than our net sales, particularly if they require sub-contractor participation.

Selling, General and Administrative Expense. Selling, general and administrative expense increased 1.2% to \$4.4 million (or 26.6% of total net sales and contract revenues) and increased 7.5% to \$14.2 million (or 26.8% of total net sales and contract revenues) in the three and nine months ended December 31, 2008, respectively, compared to \$4.3 million (or 28.2% of total net sales and contract revenues) and \$13.2 million (or 27.4% of total net sales and contract revenues) in the corresponding periods of the prior fiscal year. These increases for the nine month period were largely attributable to higher selling expenses in our Transportation Systems segment, as a result of a shift in labor resources from project related activities to sales and marketing efforts, aimed at capturing additional contract backlog, and as a result, Transportation Systems sales & marketing expense increased to \$2.1 million during the nine months ended December 31, 2008 compared to \$1.3 million for the same period in the prior year.

[Table of Contents](#)

Research and Development Expense. Research and development expense decreased 15.4% to \$848,000 (or 5.2% of total net sales and contract revenues) and increased 21.2% to \$3.2 million (or 6.0% of total net sales and contract revenues) in the three and nine months ended December 31, 2008, respectively, compared to \$1.0 million (or 6.5% of total net sales and contract revenues) and \$2.6 million (or 5.5% of total net sales and contract revenues) in the corresponding periods of the prior fiscal year. Research and development expense decreased in the third quarter mainly because many of the Company's expenditures to bring new products to market were incurred in its first two fiscal quarters. The increase for the nine month period was primarily due to increased research and development activities in Roadway Sensors aimed at accelerating the time to market of certain new products. We believe research and development activities are crucial to our ability to continue to be a leader in our markets, and we expect our expenditures in this area to continue to run at an increased level, compared to the prior year, for the remainder of fiscal 2009.

For competitive reasons, we closely guard the confidentiality of specific development projects.

Interest Expense, Net. Interest expense, net includes the following:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2008	2007	2008	2007
	(in thousands)			
Interest expense	\$ (106)	\$ (228)	\$ (366)	\$ (787)
Amortization of debt discount	(21)	(51)	(103)	(155)
Amortization of deferred finance costs	(14)	(35)	(68)	(104)
Interest expense, net	<u>\$ (141)</u>	<u>\$ (314)</u>	<u>\$ (537)</u>	<u>\$ (1,046)</u>

Interest expense decreased for the three and nine months ended December 31, 2008 compared to the corresponding period in the prior fiscal year as a result of an overall lower level of borrowings in the current periods and as a result of the early retirement of certain of the Company's convertible debentures.

Income Taxes. During the three and nine months ended December 31, 2008, we recognized income tax expense of \$415,000 and \$1.7 million, respectively, as compared to income tax benefits of \$141,000 and \$221,000 in the three and nine months ended December 31, 2007, respectively. The increase in income tax expense and our effective tax rate in the current year periods was primarily due to the reduction of the valuation allowance recorded against our deferred tax assets in the prior year periods as a result of changes in our estimates of the future realizability of these assets. We analyze our tax estimates quarterly, and should those estimates result in an increase in future taxable income, we may continue to reduce our deferred tax asset valuation allowance, which totaled approximately \$8.0 million at December 31, 2008. This could cause our future overall effective tax rate in any given period to fluctuate from prior effective tax rates, estimated annual effective tax rates and statutory tax rates.

Liquidity and Capital Resources

Cash Flows

We have historically financed our operations with a combination of cash flows from operations, borrowings under credit facilities and the sale of debt and equity securities. We currently rely on cash flows from operations and borrowings on a line of credit facility to fund our operations. At December 31, 2008, we had \$15.8 million in working capital, no borrowings on our \$12.0 million working capital line of credit and \$6.0 million in cash and cash equivalents. This compares to working capital of \$14.9 million at March 31, 2008, which included no borrowings on our line of credit and \$421,000 in cash and cash equivalents.

Our operating activities provided \$6.0 million in cash during the nine months ended December 31, 2008, primarily as a result of net income generated during the period and the usage of deferred tax assets. We expect to continue to utilize our deferred tax assets to significantly reduce cash tax payments in future quarters. Accounts receivable decreased during the nine months ended December 31, 2008 by \$258,000 primarily due to decreased sales and the timing of invoicing and collections for all segments. Net unbilled accounts receivable also decreased by \$2.0 million during the nine months ended December 31, 2008 as a result of the timing of invoicing in Transportation Systems. Inventories increased by \$771,000 as a result of flat product sales, the introduction of new products by Roadway Sensors and the acquisition of certain components because they have been discontinued by the manufacturer. We expect inventories to slightly increase for the remainder of fiscal 2009.

[Table of Contents](#)

Our investing activities for the nine months ended December 31, 2008 and 2007 consisted entirely of purchases of property and equipment, which aggregated \$716,000 and \$455,000, respectively.

Cash provided by financing activities was \$240,000 in the nine months ended December 31, 2008, which was primarily the result of \$911,000 in proceeds from the exercise of outstanding stock options to purchase our common stock and borrowings of \$5.1 million pursuant to the Company's term note, offset by \$5.8 million used to redeem convertible debentures. During the nine months ended December 31, 2007, financing activities used \$4.3 million of cash, which was the result of \$5.6 million in net payments against borrowings, partially offset by \$1.3 million in proceeds from the exercise of outstanding stock options and warrants to purchase our common stock.

Borrowings

The following table summarizes our borrowings and long-term debt:

	At December 31, 2008 (In thousands)
Convertible debentures, net	\$ 2,232
Bank term note	5,073
	<u>\$ 7,305</u>

Until October 15, 2008, we had a credit facility with Silicon Valley Bank that provided for line of credit borrowings of up to \$10.0 million. Under this credit facility, we could borrow against eligible accounts receivable and eligible inventory, as defined in the credit agreement. Interest on borrowed amounts under the line of credit was payable monthly at the current stated prime rate plus 1.00%. Additionally, we were obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeded the average daily principal balance during the preceding month. The credit facility required \$2,000 in monthly collateral management fees and included an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. The credit facility was secured by substantially all of our assets. This credit facility expired on October 15, 2008.

Effective October 16, 2008, we entered into a new \$19.5 million credit facility with California Bank & Trust, which replaced our \$10.0 million facility with Silicon Valley Bank. This new credit facility provides for a \$12.0 million, two-year, revolving line of credit and a term note of up to \$7.5 million as discussed below. Interest on borrowed amounts under the revolving line will be payable monthly at a rate equal to the current stated prime rate up to the current stated prime rate plus 0.50%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility. We are obligated to pay an unused line fee of 0.25% per annum applied to the average unused portion of the \$12.0 million revolving line of credit during the preceding month. No amounts were borrowed under the \$12.0 million revolving line of credit as of December 31, 2008.

Additionally, as part of this new credit facility and in connection with the early retirement of \$7.0 million of our convertible debentures, we have borrowed \$6.5 million (\$5.07 million in October 2008 and \$1.47 million in January 2009) and may borrow up to another \$1.0 million in the form of a \$7.5 million 48-month term note to retire all outstanding debentures. Principal payments under this term note are required to be repaid in 48 monthly installments commencing on June 1, 2009. Interest on the term note will be payable monthly at a rate equal to the current stated prime rate plus 0.50% up to the current stated prime rate plus 1.00%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility. In October 2008, we paid an upfront loan commitment fee of \$28,000 in connection with the term note portion of the credit facility. The new credit facility contains no early termination fees and is secured by substantially all of our assets.

On February 4, 2009 we entered into an Amended and Restated Loan and Security Agreement with California Bank & Trust which supersedes the agreements entered into on October 16, 2008 in their entirety. The October 16, 2008 documents were amended and restated to clarify the meaning of certain ambiguities and remove non-applicable language. No modifications were made to any significant provisions related to the overall amount of the credit facility, interest rate calculations, or any financial or non-financial covenant.

We believe that the cash generated from our operations, together with funds available under our credit facility, will be sufficient to fund our operations for at least the next twelve months. However, should a shortfall occur, we may need to raise additional funds through other debt or equity financings.

Contractual Obligations

Our contractual obligations at December 31, 2008, updated to reflect the early retirement and refinancing of convertible debentures in January 2009, were as follows:

	Payments Due by Fiscal Year						Total
	2009	2010	2011	2012	2013	Thereafter	
	(In thousands)						
Term note payable	\$ —	\$ 1,870	\$ 2,144	\$ 2,144	\$ 415	\$ —	\$ 6,573
Convertible debentures	—	750	—	—	—	—	750
Operating leases	812	1,661	1,444	1,365	1,380	2,460	9,122
Total	<u>\$ 812</u>	<u>\$ 4,281</u>	<u>\$ 3,588</u>	<u>\$ 3,509</u>	<u>\$ 1,795</u>	<u>\$ 2,460</u>	<u>\$ 16,445</u>

At December 31, 2008, we had firm commitments to purchase inventory in the amount of \$2.5 million during our next three fiscal quarters.

Off Balance Sheet Arrangements

In May 2004, we issued subordinated convertible debentures in an aggregate original principal amount of \$10.1 million. These debentures are due in full on May 18, 2009 and are convertible into shares of our common stock at an initial conversion price of \$3.61 per share. To date, all but \$750,000 of these debentures have been retired. Because these debentures are conventionally convertible, we have not separately accounted for the conversion feature and, accordingly, no separate amounts are presented in our condensed consolidated financial statements in connection with this conversion feature.

At December 31, 2008, outstanding warrants to purchase an aggregate of 246,250 shares of our common stock at an exercise price of \$3.25 per share were callable by us if the closing sales price of our common stock for 20 consecutive days is equal to or greater than two times the exercise price of the warrants. Outstanding warrants to purchase an aggregate of 75,000 shares of our common stock at an exercise price of \$5.00 per share were callable by us if the price of our common stock for 20 consecutive days is equal to or greater than one and a half times the exercise price of the warrants.

In connection with warrants to purchase 246,250 shares of our common stock at an exercise price of \$3.25 per share, we are a party to a registration rights agreement that contains provisions under which we could be subjected to liquidated damages should we fail to maintain effective registration statements for the underlying shares of common stock. These warrants have been accounted for within equity in our condensed consolidated balance sheets in accordance with Emerging Issues Task Force Issue 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and, accordingly, no liabilities have been recorded in connection therewith. As of the date of this filing, no liquidated damages are payable under the provisions of the registration rights agreement associated with these warrants.

Seasonality

We have historically experienced, and expect to continue to experience, seasonality, particularly with respect to our Roadway Sensors net sales in the third and fourth fiscal quarters due to a reduction in road construction or repairs during the winter months in many markets as a result of inclement weather conditions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk is limited to our line of credit and our new bank term note. Our line of credit bears interest equal to the prevailing prime rate (3.25% at December 31, 2008) plus 0% to 1.0%. We do not believe that a 10% increase in the interest rate on our line of credit or term note (from 3.25% to 3.58%) would have a material impact on our financial position, operating results or cash flows. In addition, we believe that the carrying value of our outstanding debt under our credit facility approximates fair value.

ITEM 4T. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Our management necessarily applied its judgment in evaluating the cost-benefit relationship of such controls and procedures.

Changes in Internal Controls

During the fiscal quarter covered by this report, there has been no change in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth under the heading "Litigation and Other Contingencies" in Note 4 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item I of this report, is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Our business is subject to a number of risks, some of which are discussed below. Other risks are presented elsewhere in this report and in the information incorporated by reference into this report. You should consider the following risks carefully in addition to the other information contained in this report and our other filings with the SEC, including our annual report on Form 10-K and subsequent reports on Forms 10-Q and 8-K, before deciding to buy, sell, or hold our common stock. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occurs, our business, financial condition, or results of operations could be seriously harmed. In that event, the market price for our common stock could decline and you may lose all or part of your investment.

THE ECONOMIC SLOWDOWN IS LEADING TO REDUCED OR DELAYED GOVERNMENT FUNDING FOR TRANSPORTATION INFRASTRUCTURE PROJECTS, AND INITIATIVES AND DECREASED AVAILABILITY OF FINANCIAL CAPITAL FOR OUR CUSTOMERS, WHICH COULD HAVE AN ADVERSE IMPACT ON OUR NET SALES AND CONTRACT REVENUES. Decreased consumer confidence, the failure of certain financial institutions and businesses, concerns about the availability and cost of credit, and reduced corporate profits and capital spending have resulted in a downturn in worldwide economic conditions, as well as budgetary shortfalls increasingly present at all levels of government. These unfavorable economic conditions have had a negative impact on customer orders and government funding of infrastructure projects incorporating our products and services. Such concerns may result in cancellations and rescheduling of backlog. In addition, the recent decline in the U.S. real estate market, particularly in new home and commercial construction, has adversely impacted new road construction and has resulted in and may continue to result in flat or slightly declining Roadway Sensor and Vehicle Sensor net sales and could impact Transportation Systems contract revenues. Any of the foregoing economic conditions make it extremely difficult for our customers, our suppliers and us to accurately forecast and plan future business activities. If such conditions continue or worsen, our business, financial condition and results of operations could be materially and adversely affected.

CURRENT BUDGETARY CONSTRAINTS AND THE SIGNIFICANT MILITARY OPERATIONS IN THE MIDDLE EAST OR ELSEWHERE MAY IMPACT GOVERNMENT FUNDING OR CONSUMER SPENDING, CAUSING A DECLINE IN OUR REVENUES. In the near term, the funding of U.S. military operations in the Middle East or elsewhere may cause disruptions in funding of government contracts. Since military operations of such magnitude are not routinely included in U.S. defense budgets, supplemental legislative funding actions are often required to finance such operations. Even when such legislation is enacted, it may not be adequate for ongoing operations, causing other government resources to be temporarily or permanently diverted. Since a significant portion of our sales are derived from contracts with government agencies, such diversion of funds could produce interruptions in funding or delays in receipt of our contracts, causing disruptions and adversely affecting our revenue and operations.

WE DEPEND ON GOVERNMENT CONTRACTS AND SUBCONTRACTS, AND BECAUSE MANY OF OUR GOVERNMENT CONTRACTS ARE FIXED PRICE CONTRACTS, HIGHER THAN ANTICIPATED COSTS WILL REDUCE OUR PROFIT AND COULD ADVERSELY IMPACT OUR OPERATING RESULTS. A significant portion of our sales are derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. Government contracts represented approximately 38.1%, 37.8% and 38.3% of our total net sales and contract revenues for the years ended March 31, 2008, 2007 and 2006, respectively. We anticipate that revenue from government contracts will continue to remain a significant portion of our net sales and contract revenues. Government business is, in general, subject to special risks and challenges, including:

- long purchase cycles or approval processes;
- competitive bidding and qualification requirements;
- the impact of international conflicts;
- delays in funding, including delays in the allocation of funds to state and local agencies from the U.S. federal government as a result of the expiration of the 2005 Federal Highway Bill in September of 2009;
- performance bond requirements;
- changes in government policies and political agendas;
- other government budgetary constraints, cut-backs, delays or reallocation of government funding;
- milestone requirements and liquidated damage provisions for failure to meet contract milestones.

In addition, a large number of our government contracts are fixed price contracts. As a result, we may not be able to recover any cost overruns we may incur. These fixed price contracts require us to estimate the total project cost based on preliminary projections of the project's requirements. The financial viability of any given project depends in large part on our ability to estimate these costs accurately and complete the project on a timely basis. In the event our costs on these projects exceed the fixed contractual amount, we will be required to bear the excess costs. Such additional costs would adversely affect our financial condition and results of operations. Moreover, certain of our government contracts are subject to termination or renegotiation at the convenience of the government, which could result in a large decline in our net sales and contract revenues in any given quarter. Our inability to address any of the foregoing concerns or the loss or renegotiation of any material government contract could seriously harm our business, financial condition and results of operations.

WE MAY EXPERIENCE PRODUCTION GAPS THAT COULD MATERIALLY AND ADVERSELY IMPACT OUR SALES AND FINANCIAL RESULTS AND THE ULTIMATE ACCEPTANCE OF OUR PRODUCTS. It is possible that we could experience unforeseen quality control issues or part shortages as we adjust production to meet current demand for our products. We have historically used single suppliers for certain of our components in our AutoVue and Vantage products. Should any such delay or disruption occur, our future sales will likely be materially and adversely affected. Additionally, we rely heavily on select contract manufacturers to produce many of our products. Although we believe our contract manufacturers have sufficient capacity to meet our production schedules for the foreseeable future and we believe we could find alternative contract manufacturing sources if necessary, we could experience a production gap if for any reason our contract manufacturers were unable to meet our production requirements.

WE MAY BE UNABLE TO ATTRACT AND RETAIN KEY PERSONNEL, WHICH COULD SERIOUSLY HARM OUR BUSINESS. Due to the specialized nature of our business, we are highly dependent on the continued service of our executive officers and other key management, engineering and technical personnel. The loss of Abbas Mohaddes, our Chief Executive Officer, or any of the other executive officers or key members of management could adversely affect our business, financial condition, or results of operations. Our success will also depend in large part upon our ability to continue to attract, retain and motivate qualified engineering and other highly skilled technical personnel. In particular, the future success of our Transportation Systems segment will depend on our ability to hire additional qualified engineers and planners. Competition for qualified employees, particularly development engineers, is intense. We may not be able to continue to attract and retain sufficient numbers of such highly skilled employees. Our inability to attract and retain additional key employees or the loss of one or more of our current key employees could adversely affect our business, financial condition and results of operations.

THE MARKETS IN WHICH WE OPERATE ARE HIGHLY COMPETITIVE AND HAVE MANY MORE ESTABLISHED COMPETITORS, WHICH COULD ADVERSELY AFFECT OUR SALES OR THE MARKET ACCEPTANCE OF OUR PRODUCTS. We compete with numerous other companies in our target markets including, but not limited to, large, multinational corporations, which include tier one automotive suppliers, and many smaller regional engineering firms. We expect such competition to increase due to technological advancements, industry consolidations and reduced barriers to entry. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could seriously harm our business, financial condition and results of operations. In fiscal 2007, we began to experience more competition in our Roadway Sensors segment as the Department of Transportation in one of our largest sales territories moved to a multi-source contracting environment from one in which we were the sole supplier. In addition, one of the other developers of LDW systems was acquired by a large multinational organization during fiscal 2009. This new competitor could be more aggressive in both the passenger car and heavy truck markets, as a result of its greater access to resources and reputation in the market. Additional new competitors may enter this market in the future. Furthermore, awareness of LDW technology is increasing and other market players are attempting to develop competing technologies, which may contain improvements or added features beyond those offered by our LDW systems. Additionally, from time to time, we may be required to re-compete for LDW business from our main customer base of heavy truck OEMs. These OEMs could make a supplier change based on price, product performance or available features. Should our competition be successful, this could erode our ability to successfully market and sell our LDW systems to new and existing customers.

Many of our competitors have far greater name recognition and greater financial, technological, marketing, and customer service resources than we do. This may allow them to respond more quickly to new or emerging technologies and changes in customer requirements. It may also allow them to devote greater resources to the development, promotion, sale and support of their products than we can. Recent consolidations of end users, distributors and manufacturers in our target markets have exacerbated this problem. As a result of the foregoing factors, we may not be able to compete effectively in our target markets and competitive pressures could adversely affect our business, financial condition and results of operations.

IF WE ARE UNABLE TO DEVELOP AND INTRODUCE NEW PRODUCTS AND PRODUCT ENHANCEMENTS SUCCESSFULLY AND IN A COST-EFFECTIVE AND TIMELY MANNER, OR ARE UNABLE TO ACHIEVE MARKET ACCEPTANCE OF OUR NEW PRODUCTS, OUR OPERATING RESULTS WOULD BE ADVERSELY AFFECTED. We believe our revenue growth and future operating results will depend on our ability to complete development of new products and enhancements, introduce these products in a timely, cost-effective manner, achieve broad market acceptance of these products and enhancements, and reduce our product costs. We cannot guarantee the success of these products and we may not be able to introduce any new products or any enhancements to our existing products on a timely basis, or at all. In addition, the introduction of any new products could adversely affect the sales of certain of our existing products.

We believe that we must continue to make substantial investments to support ongoing research and development in order to remain competitive. We need to continue to develop and introduce new products that incorporate the latest technological advancements in outdoor image processing hardware, software and camera technologies in response to evolving customer requirements. We cannot assure you that we will be able to adequately manage product transition issues. Our business and results of operations could be adversely affected if we do not anticipate or respond adequately to technological developments or changing customer requirements or if we cannot adequately manage inventory issues typically related to new product transitions and introductions. We cannot assure you that any such investments in research and development will lead to any corresponding increase in revenue.

Market acceptance of our new products depends upon many factors, including our ability to accurately predict market requirements and evolving industry standards, our ability to resolve technical challenges in a timely and cost-effective manner, qualify any new products with OEMs and achieve manufacturing efficiencies, the perceived advantages of our new products over traditional products and the marketing capabilities of our independent distributors and strategic partners, including Valeo's ability to expand sales of AutoVue in the passenger car market. The success of our AutoVue system will also depend in part on the success of the automotive vehicles that incorporate our technology, as well as the success of optional equipment that OEMs bundle with our technologies.

[Table of Contents](#)

Certain of the components used in our Vantage and AutoVue products may need to be re-engineered in the next 12 to 36 months as the industry is moving towards a standard of using lead-free components. We cannot assure you as to the timing of the adoption of this new standard or our ability to successfully redesign our products to incorporate compliant components and gain market acceptance of such redesigned products. In addition, if the standard is adopted earlier than anticipated we may experience a shortage of Vantage and AutoVue products as a result of potential scarcity of lead-free components.

Our business and results of operations could also be seriously harmed by any significant delays in our new product development. Certain of our new products could contain undetected design faults and software errors or “bugs” when first released by us, despite our testing. We may not discover these faults or errors until after a product has been installed and used by our customers. Any faults or errors in our existing products or in any new products may cause delays in product introduction and shipments, require design modifications or harm customer relationships, any of which could adversely affect our business and competitive position.

NEW ENVIRONMENTAL REGULATIONS MAY RESULT IN A DECLINE IN OUR VEHICLE SENSORS NET SALES. From time to time, environmental regulations are enacted, which can significantly increase the cost of manufacturing new vehicles as well as the cost of maintenance of existing vehicles and truck fleets. As a result, we could experience a decline in sales of our Vehicle Sensors products as truck and vehicle manufacturers and fleet operators attempt to control their costs.

WE MAY ENGAGE IN ACQUISITIONS OF COMPANIES OR TECHNOLOGIES THAT MAY REQUIRE US TO UNDERTAKE SIGNIFICANT CAPITAL INFUSIONS AND COULD RESULT IN DISRUPTIONS OF OUR BUSINESS AND DIVERSION OF RESOURCES AND MANAGEMENT ATTENTION. We have historically acquired, and may in the future acquire, complementary businesses, products, and technologies. Acquisitions may require significant capital infusions and, in general, acquisitions also involve a number of special risks, including:

- potential disruption of our ongoing business and the diversion of our resources and management’s attention;
- the failure to retain or integrate key acquired personnel;
- the challenge of assimilating diverse business cultures, and the difficulties in integrating the operations, technologies and information system of the acquired companies;
- increased costs to improve managerial, operational, financial and administrative systems and to eliminate duplicative services;
- the incurrence of unforeseen obligations or liabilities;
- potential impairment of relationships with employees or customers as a result of changes in management; and
- increased interest expense and amortization of acquired intangible assets.

Our competitors are also soliciting potential acquisition candidates, which could both increase the price of any acquisition targets and decrease the number of attractive companies available for acquisition. Acquisitions may also materially and adversely affect our operating results due to large write-offs, contingent liabilities, substantial depreciation, deferred compensation charges or intangible asset amortization, or other adverse tax or accounting consequences. We cannot assure you that we will be able to identify or consummate any additional acquisitions, successfully integrate any acquisitions or realize the benefits anticipated from any acquisition.

WE DEPEND UPON VALEO TO MARKET OUR AUTOVUE TECHNOLOGIES FOR THE OEM PASSENGER CAR MARKET. We have granted Valeo the exclusive right to sell and manufacture our AutoVue LDW system to the worldwide passenger car market in exchange for royalty payments for each AutoVue unit sold. As such, the future success and broad market acceptance of our AutoVue technologies in the passenger car market will depend upon Valeo’s ability to manufacture market and sell our technologies, and to convince more OEM passenger car manufacturers to adopt our technologies. To date, we have not generated significant royalties from Valeo’s efforts and have only been designed into one car OEM product line. If Valeo does not devote considerable resources and aggressively pursue opportunities, our expansion into the passenger car market could be adversely affected.

IF WE DO NOT KEEP PACE WITH RAPID TECHNOLOGICAL CHANGES AND EVOLVING INDUSTRY STANDARDS, WE WILL NOT BE ABLE TO REMAIN COMPETITIVE AND THERE WILL BE NO DEMAND FOR OUR PRODUCTS. Our markets are in general characterized by the following factors:

- rapid technological advances;
- downward price pressure in the marketplace as technologies mature;
- changes in customer requirements;
- additional qualification requirements related to new products or components;
- frequent new product introductions and enhancements;
- inventory issues related to transition to new or enhanced models; and
- evolving industry standards and changes in the regulatory environment.

Our future success will depend upon our ability to anticipate and adapt to changes in technology and industry standards, and to effectively develop, introduce, market and gain broad acceptance of new products and product enhancements incorporating the latest technological advancements. In particular, our LDW system is incorporated into automobiles and trucks that face significant technological changes in each model year and among different vehicle models. Accordingly, we must adapt our technology from time to time to function with such changes.

OUR INTERNATIONAL BUSINESS OPERATIONS MAY BE THREATENED BY MANY FACTORS THAT ARE OUTSIDE OF OUR CONTROL. We currently market our AutoVue and Vantage products internationally and we anticipate that our international operations will expand in the near future. International business operations are subject to various inherent risks including, among others:

- currency fluctuations and restrictions;
- political, social and economic instability;
- longer accounts receivable payment cycles;
- import and export license requirements and restrictions of the United States and each other country in which we operate;
- unexpected changes in regulatory requirements, tariffs and other trade barriers or restrictions;
- the burdens of compliance with a wide variety of foreign laws and more restrictive labor laws and obligations;
- difficulties in managing and staffing international operations;
- potentially adverse tax consequences; and
- reduced protection for intellectual property rights in some countries.

All of our international sales are denominated in U.S. dollars. As a result, an increase in the relative value of the dollar could make our products more expensive and potentially less price competitive in international markets. We do not engage in any transactions as a hedge against risks of loss due to foreign currency fluctuations.

Any of the factors mentioned above may adversely affect our future international sales and, consequently, affect our business, financial condition and operating results. Furthermore, as we increase our international sales, our total revenues may also be affected to a greater extent by seasonal fluctuations resulting from lower sales that typically occur during the summer months in Europe and other parts of the world.

IF OUR INTERNAL CONTROLS OVER FINANCIAL REPORTING DO NOT COMPLY WITH THE REQUIREMENTS OF THE SARBANES-OXLEY ACT, OUR BUSINESS AND STOCK PRICE COULD BE ADVERSELY AFFECTED. Section 404 of the Sarbanes-Oxley Act of 2002 currently requires us to evaluate the effectiveness of our internal controls over financial reporting at the end of each fiscal year and to include a management report assessing the effectiveness of our internal controls over financial reporting in all annual reports. Section 404 also requires our independent registered public accounting firm to attest to, and report on, management's assessment of our internal controls over financial reporting beginning with our fiscal year ending March 31, 2010. We may not be able to complete the work required for such attestation on a timely basis, and even if we timely complete such requirements, our independent auditors may still conclude that our internal controls over financial reporting are not effective.

Our management, including our CEO and CFO, does not expect that our internal controls over financial reporting will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Iteris have been or will be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions. Over time, our controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

As of March 31, 2005, we became aware of a material weakness in our internal controls related to the accounting for the consolidation of our deferred compensation savings plan and certain contract administration. Based on our evaluation, our management concluded that, as of March 31, 2004, our internal control over financial reporting was not effective due to the existence of one material weakness. The weakness was immediately corrected. We cannot assure you that we or our independent registered public accounting firm will not identify additional material weaknesses in our internal controls. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. If our internal controls over financial reporting are not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

WE MAY NEED TO RAISE ADDITIONAL CAPITAL IN THE FUTURE, WHICH MAY NOT BE AVAILABLE ON TERMS ACCEPTABLE TO US, OR AT ALL. Until recently, we have historically generated significant net losses and operating losses, and have experienced volatility in our cash flows from operations ranging from positive cash flows from operations of \$7.6 million in the fiscal year ended March 31, 2008 to negative cash flows from operations of \$2.0 million in the fiscal year ended March 31, 2007. Although we entered into a new \$19.5 million credit facility, effective October 2008, should we have an event of default, which includes, among other things, a failure to meet certain financial covenants and a material adverse change in the business, the bank could choose to limit or take away our ability to borrow these or any funds. Should this occur, or if the credit markets further tighten, we may need or choose to raise additional capital to refinance the remaining debentures, pursue acquisitions or to expand our operations.

At December 31, 2008, we had \$6.0 million of cash and cash equivalents and our entire \$12.0 million line of credit to fund our operations. We may need to raise additional capital in the near future to fund our operations or to repay indebtedness. Such additional capital may be raised through bank borrowings, or other debt or equity financings. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all, and such additional financing may result in further dilution to our stockholders.

Our capital requirements will depend on many factors, including, but not limited to:

- market acceptance of our products and product enhancements, and the overall level of sales of our products;
- our ability to control costs;
- the supply of key components for our products;
- our ability to increase revenue and net income;
- increased research and development expenses and sales and marketing expenses;

[Table of Contents](#)

- our need to respond to technological advancements and our competitors' introductions of new products or technologies;
- capital improvements to new and existing facilities and enhancements to our infrastructure and systems;
- potential acquisitions of businesses and product lines;
- our relationships with customers and suppliers;
- government budgets, political agendas and other funding issues, including potential delays in government contract awards;
- our ability to successfully negotiate credit arrangements with our bank and repay our subordinated convertible debentures; and
- general economic conditions, including the effects of the current economic slowdown and international conflicts.

If our capital requirements are materially different from those currently planned, we may need additional capital sooner than anticipated. If additional funds are raised through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced and such securities may have rights, preferences and privileges senior to our common stock. Additional financing may not be available on favorable terms, on a timely basis, or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue our operations as planned, develop or enhance our products, expand our sales and marketing programs, take advantage of future opportunities or respond to competitive pressures.

OUR QUARTERLY OPERATING RESULTS FLUCTUATE AS A RESULT OF MANY FACTORS. THEREFORE, WE MAY FAIL TO MEET OR EXCEED THE EXPECTATIONS OF SECURITIES ANALYSTS AND INVESTORS, WHICH COULD CAUSE OUR STOCK PRICE TO DECLINE.

Our quarterly revenues and operating results have fluctuated and are likely to continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. Factors that could affect our revenues include, among others, the following:

- changes in our pricing policies and the pricing policies of our suppliers and competitors, pricing concessions on volume sales, as well as increased price competition in general;
- the long lead times associated with government contracts or required by vehicle manufacturers;
- the size, timing, rescheduling or cancellation of significant customer orders;
- delays in government contracts and funding from time to time and budgetary constraints at the federal, state and local levels;
- declines in new home construction and related road and other infrastructure construction;
- our ability to control costs;
- our ability to raise additional capital;
- the mix of our products and services sold in a quarter, which mix has varied and is expected to continue to vary from time to time;
- seasonality due to winter weather conditions;
- international conflicts and acts of terrorism;
- our ability to develop, introduce, patent, market and gain market acceptance of new products, applications and product enhancements in a timely manner, or at all;
- market acceptance of the products incorporating our technologies and products;

[Table of Contents](#)

- the introduction of new products by competitors;
- the availability and cost of components used in the manufacture of our products;
- our success in expanding and implementing our sales and marketing programs;
- the effects of technological changes in our target markets;
- the amount of our backlog at any given time;
- the nature of our government contracts;
- deferrals of customer orders in anticipation of new products, applications or product enhancements;
- risks and uncertainties associated with our international business;
- currency fluctuations and our ability to get currency out of certain foreign countries; and
- general economic and political conditions.

Due to all of the factors listed above as well as other unforeseen factors, our future operating results could be below the expectations of securities analysts or investors. If that happens, the trading price of our common stock could decline. As a result of these quarterly variations, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of our future performance.

WE HAVE EXPERIENCED GROWTH IN RECENT PERIODS. IF WE FAIL TO MANAGE OUR GROWTH EFFECTIVELY, WE MAY BE UNABLE TO EXECUTE OUR BUSINESS PLAN AND MAY EXPERIENCE FUTURE WEAKNESSES IN OUR INTERNAL CONTROLS. We have expanded our overall business. In order to achieve our business objectives, we will need to continue to expand our business and add additional qualified personnel. Such expansion has placed and is expected to continue to place, a significant strain on our managerial, administrative, operational, financial and other resources. If we are unable to successfully manage our growth, our business, financial condition and results of operations will be adversely affected.

WE MAY NOT BE ABLE TO ADEQUATELY PROTECT OR ENFORCE OUR INTELLECTUAL PROPERTY RIGHTS, WHICH COULD HARM OUR COMPETITIVE POSITION. If we are not able to adequately protect or enforce the proprietary aspects of our technology, competitors could be able to access our proprietary technology and our business, financial condition and results of operations will likely be seriously harmed. We currently attempt to protect our technology through a combination of patent, copyright, trademark and trade secret laws, employee and third party nondisclosure agreements and similar means. Despite our efforts, other parties may attempt to disclose, obtain or use our technologies or systems. Our competitors may also be able to independently develop products that are substantially equivalent or superior to our products or design around our patents. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. As a result, we may not be able to protect our proprietary rights adequately in the United States or abroad.

Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Litigation may also be necessary to defend against claims of infringement or invalidity by others. An adverse outcome in litigation or any similar proceedings could subject us to significant liabilities to third parties, require us to license disputed rights from others or require us to cease marketing or using certain products or technologies. We may not be able to obtain any licenses on terms acceptable to us, or at all. We also may have to indemnify certain customers or strategic partners if it is determined that we have infringed upon or misappropriated another party's intellectual property. Any of these results could adversely affect our business, financial condition and results of operations. In addition, the cost of addressing any intellectual property litigation claim, including legal fees and expenses, and the diversion of management's attention and resources, regardless of whether the claim is valid, could be significant and could seriously harm our business, financial condition and results of operations.

WE HAVE HISTORICALLY EXPERIENCED SUBSTANTIAL LOSSES AND MAY EXPERIENCE LOSSES IN THE FUTURE. Although we have achieved net income in our past three fiscal years, we experienced a net loss of \$11.3 million in the year ended March 31, 2005 and significant net losses in prior years. We cannot assure you that we will be able to sustain or improve our financial performance, or that we will be able to continue to achieve profitability on a quarterly or annual basis in the future. Most of our expenses are fixed in advance. As such, we generally are unable to reduce our expenses significantly in the short-term to compensate for any unexpected delay or decrease in anticipated revenues. As a result, we may continue to experience operating losses and net losses, which would make it difficult to fund our operations and achieve our business plan, and could cause the market price of our common stock to decline.

THE TRADING PRICE OF OUR COMMON STOCK IS HIGHLY VOLATILE. The trading price of our common stock has been subject to wide fluctuations in the past. Since January 2000, our Class A common stock (now known as our common stock) has traded at prices as low as \$0.45 per share and as high as \$29.44 per share. The market price of our common stock could continue to fluctuate in the future in response to various factors, including, but not limited to:

- quarterly variations in operating results;
- our ability to control costs, improve cash flow and sustain profitability;
- our ability to raise additional capital;
- shortages announced by suppliers;
- announcements of technological innovations or new products or applications by our competitors, customers or us;
- transitions to new products or product enhancements;
- acquisitions of businesses, products or technologies;
- the impact of any litigation;
- changes in investor perceptions;
- government funding, political agendas and other budgetary constraints;
- changes in earnings estimates or investment recommendations by securities analysts; and
- international conflicts, political unrest and acts of terrorism.

The stock market in general has from time to time experienced volatility, which has often affected the market prices of equity securities of many technology companies. This volatility has often been unrelated to the operating performance of these companies. These broad market fluctuations may adversely affect the market price of our common stock. In the past, companies that have experienced volatility in the market price of their securities have been the subject of securities class action litigation. If we were to become the subject of a class action lawsuit, it could result in substantial losses and divert management's attention and resources from other matters.

WE COULD EXPERIENCE NEGATIVE FINANCIAL IMPACTS ARISING FROM DEVELOPMENTS IN CONTINGENCIES CREATED UNDER OUR PREVIOUS STRUCTURE OR BY FORMER SUBSIDIARIES. Although we divested ourselves of all business units prior to October 2004, with the exception of our Iteris business, from time to time we could experience unforeseen developments in contingencies related to our former subsidiaries. For example, in July 2006 we entered into a settlement agreement in connection with a lawsuit brought against Mariner Networks, Inc., one of our former subsidiaries, by one of Mariner's suppliers, pursuant to which we issued 88,912 shares of our common stock to this supplier (valued at \$213,000 as of the date of issuance), paid this supplier \$125,000 on October 20, 2006 and are required to pay an additional \$350,000 in 36 equal monthly installments of \$9,700 through October 2009. Although we are not aware of any other material contingencies, it is possible other matters could be brought against us in connection with activities related to former subsidiaries and that such matters could materially and adversely affect our financial results and cash flows.

SOME OF OUR DIRECTORS, OFFICERS AND THEIR AFFILIATES CAN CONTROL THE OUTCOME OF MATTERS THAT REQUIRE THE APPROVAL OF OUR STOCKHOLDERS, AND ACCORDINGLY WE WILL NOT BE ABLE TO ENGAGE IN CERTAIN TRANSACTIONS WITHOUT THEIR APPROVAL. As of December 31, 2008, our officers and directors beneficially owned approximately 11% of the outstanding shares of our common stock (and approximately 15% of our common stock when including options, warrants and other convertible securities held by them which are currently exercisable or convertible or will become exercisable or convertible within 60 days after December 31, 2008). As a result of their stock ownership, our management will be able to influence the election of our directors and the outcome of corporate actions requiring stockholder approval, such as mergers and acquisitions, regardless of how our other stockholders may vote. This concentration of voting control may have a significant effect in delaying, deferring or preventing a change in our management or change in control and may adversely affect the voting or other rights of other holders of common stock.

CERTAIN PROVISIONS OF THE COMPANY'S CHARTER DOCUMENTS MAY DISCOURAGE A THIRD PARTY FROM ACQUIRING US AND MAY ADVERSELY AFFECT THE PRICE OF OUR COMMON STOCK. Certain provisions of our certificate of incorporation could make it difficult for a third party to acquire us, even though an acquisition might be beneficial to our stockholders. Such provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. Under the terms of our certificate of incorporation, our Board of Directors is authorized to issue, without stockholder approval, up to 2,000,000 shares of preferred stock with voting, conversion and other rights and preferences superior to those of our common stock. Our future issuance of preferred stock also could be used to effect a shareholder rights plan which could discourage an unsolicited acquisition proposal.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

One of our executive officers, James S. Miele, has entered into a trading plan pursuant to Rule 10b5-1(c)(1) of the Securities Exchange Act of 1934, as amended, which covers an aggregate of 40,000 shares of our common stock not to be sold at a price below \$2.75. The options shares are set to expire on September 26, 2011.

On February 4, 2009 the Company entered into an Amended and Restated Loan and Security Agreement with California Bank & Trust which supersedes the agreements entered into on October 16, 2008 in their entirety. The Amended and Restated Loan and Security Agreement is included as an exhibit with the filing (Exhibit 10.1). The October 16, 2008 documents were amended and restated to clarify the meaning of certain ambiguities and remove non-applicable language. No modifications were made to any significant provisions related to the overall amount of the credit facility, interest rate calculations, or any financial or non-financial covenant.

ITEM 6. EXHIBITS

The following exhibits are filed herewith or are incorporated by reference to the location indicated.

Exhibit Number	Description	Where Located
3.1	Amended and Restated Certificate of Incorporation of the registrant	<i>Exhibit 3.1 to the registrant's Current Report on Form 8-K as filed with the SEC on October 28, 2004</i>
3.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation filed September 26, 2007	<i>Exhibit 3.2 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 as filed with the SEC on November 13, 2007</i>
3.3	Bylaws of registrant, as amended	<i>Exhibit 4.2 to the registrant's Registration Statement on Form S-1 (Reg. No. 033-67932) as filed with the SEC on July 6, 1993</i>
3.4	Certificates of Amendment to Bylaws of the registrant dated April 24, 1998 and August 10, 2001	<i>Exhibit 3.4 to the registrant's Annual Report on Form 10-K/A for the year ended March 31, 2003 as filed with the SEC on July 29, 2003</i>
3.5	Certificate of Amendment to Bylaws of registrant dated September 9, 2004	<i>Exhibit 3.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 as filed with the SEC on November 15, 2004</i>
3.6	Certificate of Amendment to Bylaws of registrant dated September 16, 2005	<i>Exhibit 3.5 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2007 as filed with the SEC on June 21, 2007</i>
3.7	Certificate of Amendment to Bylaws of registrant dated December 7, 2007	<i>Exhibit 3.1 to the registrant's Current Report on Form 8-K as filed with the SEC on December 13, 2007</i>
4.1	Specimen of Common Stock Certificate	<i>Exhibit 4.1 to the registrant's Amendment No. 1 to the Registration Statement on Form 8-A as filed with the SEC on December 8, 2004</i>
10.1	Amended and Restated Loan and Security Agreement on February 4, 2009 by and between California Bank & Trust and the registrant	<i>Filed herewith</i>
10.2	Debenture Redemption Agreement, dated October 17, 2008, by and between the registrant and certain affiliates of Bryant R. Riley	<i>Filed herewith</i>
10.3	Debenture Redemption Agreement, dated October 27, 2008, by and between the registrant and each of Lloyd I. Miller, III, Lloyd I. Miller Trust A-4, Milfam I, L.P. and Milfam II, L.P.	<i>Filed herewith</i>
10.4	Debenture Redemption Agreement, dated January 9, 2009, by and between the registrant and each of Irvin Kessler and Provident Premier Master Fund Ltd.	<i>Filed herewith</i>
31.1	Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>
31.2	Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>
32.1	Certification of the Chief Executive Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>
32.2	Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: February 12 , 2009

ITERIS, INC.
(Registrant)

By /S/ ABBAS MOHADDES

Abbas Mohaddes
Chief Executive Officer
(Principal Executive Officer)

By /S/ JAMES S. MIELE

James S. Miele
Chief Financial Officer
(Principal Financial and Accounting Officer)

AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT

THIS LOAN AND SECURITY AGREEMENT (this "Agreement") is entered into at Irvine, California, as of February 4, 2009, between Iteris, Inc., a Delaware corporation, with its chief executive office located at 1700 Carnegie Avenue, Suite 100, Santa Ana, California 92705 ("Borrower") and California Bank & Trust, a California banking corporation, with an address of Orange County Corporate Banking Office, 19200 Von Karman Avenue, Suite 140, Irvine, California 92612 ("Bank").

WHEREAS, Borrower and Bank are parties to that certain Business Loan Agreement, dated as of October 16, 2008 (the "Original Agreement"), pursuant to which Bank agreed to make a commercial loan and extend other financial accommodations to Borrower, including a revolving line of credit in the original principal amount of \$12,000,000.00 and a non-revolving-to-term loan in the original principal amount of \$7,500,000.00, in accordance with the terms and conditions set forth in the Original Agreement;

WHEREAS, Borrower desires and Bank will agree to amend and restate the Original Agreement in order to modify and amend the terms and conditions thereof, including without limitation extending of the term of commercial loans and other financial accommodations extended therein, all on the terms and conditions set forth herein;

FOR VALUE RECEIVED, and in consideration of the granting by Bank of financial accommodations to or for the benefit of Borrower, the Original Agreement is hereby amended and restated in its entirety, and Borrower represents and agrees with Bank, as of the date hereof and as of the date of each loan, credit and/or other financial accommodation, as follows:

1. THE LOANS

1.1 Loans. Subject to the terms and conditions of this Agreement, Bank hereby agrees to make loans and extend financial accommodations to or for the benefit of Borrower in the original aggregate principal amount of up to Nineteen Million, Five Hundred Thousand and No/100 Dollars (\$19,500,000.00) (collectively, the "Loans") as follows:

(a) Revolving Loan. Bank agrees to make a revolving loan and advances thereunder (collectively, the "Revolving Loan") to or for the account of Borrower, upon Borrower's request therefor, in an aggregate amount of up to Twelve Million and No/100 Dollars (\$12,000,000.00) (the "Revolving Loan Amount"), provided there is no continuing uncured Event of Default and subject to the terms and conditions set forth herein. The Revolving Loan shall be evidenced by that certain Revolving Note, dated as of even date herewith (the "Revolving Note"), by Borrower in favor of Bank in the face amount of the Revolving Loan Amount. If not earlier terminated, Bank's agreement to make any advances under the Revolving Loan pursuant to this Agreement shall expire on October 1, 2010.

(i) The proceeds of the Revolving Loan shall be used to support the working capital needs of Borrower.

(ii) So long as the Revolving Loan shall be outstanding or Bank shall have any obligation to lend thereunder, up to an aggregate amount of \$6,000,000.00 of the Revolving Loan Amount may be used by Borrower for the acquisition of businesses, products, technologies and consulting services that are complementary to the business or operations of Borrower (each, an "Acquisition"), provided there is no continuing uncured Event of Default and subject to the terms and conditions set forth herein. If one or more advances are sought by Borrower for a single Acquisition exceed an aggregate amount of \$1,500,000.00, such requests for advances must be approved in writing by Bank, in its sole discretion, in advance based on the completion of a full and adequate due diligence review by Bank of the proposed Acquisition and any and all documents, materials and information required by Bank with respect to such Acquisition.

(b) **Non-Revolving-to-Term Loan.** Bank agrees to make a non-revolving-to-term loan (the “Non-Revolving-to-Term Loan”) for Borrower pursuant to which Bank agrees, in its sole discretion, to lend to Borrower, upon Borrower’s request, up to Seven Million, Five Hundred Thousand and No/100 Dollars (\$7,500,000.00) (the “Term Loan Amount”), provided there is no continuing uncured Event of Default and subject to the terms and conditions set forth herein, for the purpose of enabling Borrower to retire certain debentures issued by Borrower. The Non-Revolving-to-Term Loan shall be evidenced by that certain Non-Revolving-to-Term Note, dated as of even date herewith (the “Non-Revolving-to-Term Note”), by Borrower in favor of Bank in the face amount of the Term Loan Amount. If not earlier terminated, Bank’s agreement to make any advances under the Non-Revolving-to-Term Loan pursuant to this Agreement shall expire on May 1, 2009 (the “Conversion Date”).

(i) On the Conversion Date, any and all indebtedness and other amounts outstanding under the Non-Revolving-to-Term Loan shall be converted into a fully amortizing term loan in accordance with the terms and conditions set forth in the Non-Revolving-to-Term Note.

(ii) Beginning on November 1, 2009, and on November 1 of each year thereafter, Borrower agrees to pay to Bank an amount equal to fifty percent (50%) of Borrower’s EBITDA for the immediately preceding fiscal year, net of taxes, capital expenditures up to \$1,500,000.00, interest paid and current portion of long-term debt for such fiscal year (the “Excess Cash Flow Recapture Amount”), which payment shall be applied to the outstanding principal balance of the Non-Revolving-to-Term Loan; *provided, however*, in no event shall Borrower’s obligation to pay the Excess Cash Flow Recapture Amount exceed \$500,000.00 in any year. Attached as Exhibit A is a form of Excess Cash Flow Recapture Amount Certificate showing how the Excess Cash Flow Recapture Amount is calculated, which shall be completed and submitted by Borrower together with Borrower’s payment of the Excess Cash Flow Recapture Amount no later than November 1 of each year.

The Revolving Note and Non-Revolving-to-Term Note are hereinafter referred to individually as a “Note” and collectively as the “Notes.” This Agreement, the Notes and any and all other documents, amendments or renewals executed and delivered in connection with any of the foregoing are collectively hereinafter referred to as the “Loan Documents.”

1.2 **Revolving Loan Account.** An account shall be opened on the books of Bank in which account a record will be kept of all advances and loans made under the Revolving Loan, all payments thereon and other appropriate debits and credits as provided by this Agreement.

1.3 **Interest.** Interest respecting indebtedness under the Revolving Loan will be charged to Borrower on the principal amount from time to time outstanding at the interest rate specified in the Revolving Note in accordance with the terms of the Revolving Note or as otherwise set forth in this Agreement with respect to any particular type of Revolving Credit. If not specified in the Revolving Note or otherwise set forth in this Agreement, interest will be charged at the highest rate per annum charged by Bank to Borrower on any other Obligation based on a 360-day year and the actual number of days elapsed.

1.4 **Repayment.** All loans and advances made respecting the Revolving Loan and the Non-Revolving-to-Term Loan shall be payable to Bank on or before the maturity date of the Revolving Note and the Non-Revolving-to-Term Note, respectively.

1.5 **Overadvances.** Any advances or loans that may be made under the Revolving Loan, at Bank’s sole discretion, in excess of the Revolving Loan Amount shall not limit the obligations of Borrower or any of Bank’s rights or remedies hereunder or under the Loan Documents or otherwise; all such advances, loans or other amounts shall be secured by the Collateral and shall be due and payable to Bank in accordance with the terms of the Revolving Note, and shall bear interest at the rate set forth in the Revolving Note.

1.6 **Notice of Borrowing.** If Bank elects to require Borrower to submit any request for an advance hereunder in writing pursuant to Section 1.9, Borrower shall promptly provide Bank with such written request, in the form of request specified by Bank, which shall specify, in addition to any other information required by Bank, (A) the amount of the requested advance and (B) the date on which such advance is to be made (which shall be a Business Day). As used in this Agreement, “Business Day” shall mean any day other than a Saturday, Sunday or other day on which banks in Los Angeles, California, are required or permitted by law to close.

1.7 Conditions to Lending.

(a) Conditions Precedent to Initial Loan. The obligation of Bank to make the Loans and the initial advances thereunder is subject to the satisfaction in full of the following conditions precedent:

(i) Corporate Documents. Bank shall have received:

(A) a copy of the articles or certificate of incorporation, articles of association or formation, certificate of limited partnership or other charter document (each, the "Charter Document") of Borrower, certified on a recent date by the Secretary of State or other relevant governmental agency of Borrower's jurisdiction of incorporation or organization;

(B) a certificate of the secretary or other appropriate officer of Borrower in the form required by Bank, dated the closing date, certifying (1) that attached thereto is a true and complete copy of the resolutions adopted by the Board of Directors (or equivalent governing body) of Borrower authorizing the execution, delivery and performance of the Loan Documents and any other documents contemplated thereunder and the grant of the security interests in the Collateral and that such resolutions have not been altered, amended, rescinded, supplemented or superseded and remain in full force and effect and (2) as to the incumbency and specimen signature of each officer of Borrower executing any Loan Documents.

(ii) Loan Documents. Bank shall have received fully executed originals (or counterpart originals) of all of the Loan Documents.

(iii) Payment of Fees. All fees and expenses then due and payable by Borrower to Bank in connection with the facility or facilities contemplated by this Agreement shall have been paid.

(iv) Financial Statements. Bank shall have received the audited financial statements of Borrower for the most recently completed fiscal year and income statements, balance sheets and statements of shareholders' equity and cash flow for Borrower's current fiscal year through the most recently completed fiscal quarter.

(v) USA PATRIOT Act. Bank shall have received from Borrower any information requested by Bank and required under or in connection with the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56 (the "USA PATRIOT Act").

(vi) Bank shall have received such other closing documentation as Bank may reasonably request.

(b) Conditions Precedent to Each Advance. The obligations of Bank to make each loan, advance or other credit under this Agreement are subject to the following conditions precedent:

(i) Notice. Bank shall have received a request for the loan, advance or other credit sought, which shall be in the form of request specified by Bank, if any, as required by Section 1.9 hereof.

(ii) Representations and Warranties. The representations and warranties set forth in Section 3 hereof and in the other Loan Documents shall be true, correct and complete in all material respects on and as of the date of each Loan.

(iii) No Event of Default. On the date of each loan, advance or other credit, no Event of Default shall have occurred and be continuing nor shall any such event occur by reason of the making of such loan, advance or other credit.

(iv) No Material Adverse Change. No event or events shall have occurred since the date of the financial statements most recently delivered to Bank that would reasonably be expected to have a materially adverse effect on the business, assets, properties, operations, financial condition, liabilities (including contingent liabilities) or material agreements of Borrower, taken as a whole, (b) materially impairs the legal right, power or authority of Borrower, taken as a whole, to perform their obligations under the Loan Documents or (c) materially impairs the validity or enforceability of the Loan Documents or the rights, remedies or benefits available to Bank thereunder.

1.8 Increased Costs.

(a) If any change in any law, rule or regulation or in the interpretation or application thereof by any governmental authority after the date of this Agreement or any compliance by Bank with any request, guideline or directive (whether or not having the force of law) of any governmental authority after the date of this Agreement (collectively, a "Change in Law") shall:

(i) impose, modify or deem applicable any reserve, special deposit or similar requirement against assets of, deposits with or for the account of, or credit extended by, Bank or

(ii) impose on Bank or the London Interbank Market any other condition affecting this Agreement or the loans hereunder made by Bank or any letter of credit or participation therein and the result of any of the foregoing shall be to increase the cost to Bank of making or maintaining any loan (or of maintaining its obligation to make any such loan) or to increase the cost to Bank of issuing or maintaining any letter of credit or to reduce the amount of any sum received or receivable by Bank hereunder (whether of principal, interest or otherwise), then Borrower will pay to Bank such additional amount or amounts as will compensate Bank for such additional costs incurred or reduction suffered.

(b) If Bank determines that any Change in Law regarding capital requirements has or would have the effect of reducing the rate of return on Bank's capital or on the capital of Bank's holding company as a consequence of this Agreement or the loans or letters of credit made or issued by Bank to a level below that which Bank or Bank's holding company could have achieved but for such Change in Law (taking into consideration Bank's policies and the policies of Bank's holding company with respect to capital adequacy), then from time to time Borrower will pay to Bank such additional amount or amounts as will compensate Bank or Bank's holding company for any such reduction suffered.

(c) A certificate of Bank setting forth in reasonable detail the amount or amounts necessary to compensate Bank or its holding company, as the case may be, and the changes as a result of which such amounts are due shall be delivered to Borrower and shall be conclusive absent manifest error. Borrower shall pay Bank the amount shown as due on any such certificate within ten (10) Business Days after receipt thereof.

(d) Failure or delay on the part of Bank to demand compensation pursuant to this section shall not constitute a waiver of Bank's right to demand such compensation.

1.9 Authorized Persons; Advances. Any person duly authorized by a general borrowing resolution of Borrower, or in the absence of such a resolution, the President, Chief Financial Officer or Controller of Borrower, or any person otherwise authorized in this paragraph, may request discretionary advances or loans hereunder, either orally or otherwise, but Bank at its option may require that all requests for loans hereunder shall be in writing. Bank shall incur no liability to Borrower in acting upon any request referred to herein which Bank believes in good faith to have been made by an authorized person or persons. Each loan hereunder may be credited by Bank to any deposit account of Borrower with Bank or with any other Bank with which Borrower maintains a deposit account, or may be paid to Borrower (or as Borrower instructs) or may be applied to any Obligations, as Bank may in each instance elect. The following persons currently are authorized to request advances and authorize payments respecting the Revolving Loan until Bank receives from Borrower, at Bank's address, written notice of revocation of their authority: James S. Miele, Chief Financial Officer, and Abbas Mohaddes, Chief Executive Officer.

1.10 Monthly Statement. At the option of Bank, after the end of each month, Bank will render to Borrower a statement of the Revolving Credit account, showing all applicable credits and debits. Each statement shall be considered correct and to have been accepted by Borrower and shall be conclusively binding upon Borrower in respect of all charges, debits and credits of whatsoever nature contained therein respecting the Revolving Loan, and the closing balance shown therein, unless Borrower notifies Bank in writing of any discrepancy within twenty (20) days from the mailing by Bank to Borrower of any such monthly statement.

2. GRANT OF SECURITY INTEREST

2.1 Grant of Security Interest. In consideration of Bank's extending credit and other financial accommodations to or for the benefit of Borrower, Borrower hereby grants to Bank a security interest in, a lien on and pledge and assignment of the Collateral. The security interest granted by this Agreement is given to and shall be held by Bank as security for the payment and performance of all Obligations, including without limitation all amounts outstanding pursuant to the Loan Documents.

2.2 Definitions. The following definitions shall apply:

(a) "Affiliate" shall mean, with respect to any person, (a) any person which, directly or indirectly through one or more intermediaries, controls, is controlled by or is under common control with such person, or (b) any person who is a director or officer of (i) such person, (ii) any subsidiary of such person, or (iii) any person described in clause (a) above. For purposes of this definition, "control" of a person shall mean the power, direct or indirect, (x) to vote 5% or more of the capital stock having ordinary voting power for the election of directors (or comparable equivalent) of such person, or (y) to direct or cause the direction of the management and policies of such person whether by contract or otherwise. Control may be by ownership, contract or otherwise.

(b) "Bank Affiliate" shall mean any Affiliate of Bank or any lender acting as a participant under any loan arrangement between Bank and Borrower.

(c) "Change in Control" shall be deemed to have occurred at such time as any of the following events shall occur:

(i) any sale, lease or other transfer (in one transaction or a series of transactions) of all or substantially all of the consolidated assets of Borrower to any Person, *provided, however*, that a transaction where the holders of all classes of Borrower's common stock immediately prior to such transaction own, directly or indirectly, more than 50% of all classes of the common stock of the continuing or surviving Person immediately after such transaction shall not be a Change in Control;

(ii) consummation of any share exchange, consolidation or merger of Borrower pursuant to which the common stock will be converted into cash, securities or other property or any sale, lease or other transfer (in one transaction or a series of transactions) of all or substantially all of Borrower's consolidated assets to any Person, *provided, however*, that a transaction where the holders of all classes of Borrower's common stock immediately prior to such transaction own, directly or indirectly, more than 50% of all classes of common stock of the continuing or surviving corporation or transferee immediately after such event shall not be a Change in Control; or

(iii) a "person or "group" (within the meaning of Section 13(d) of the Exchange Act (other than Borrower, or Borrower's employee benefit plans) files a Schedule 13D or a Schedule TO, disclosing that it has become the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act) of Borrower's common stock representing more than 50% of the voting power of common stock.

For purposes of defining a Change in Control:

- (x) whether a person is a “beneficial owner” will be determined in accordance with Rule 13d-3 under the Exchange Act; and
- (y) a “person” includes any syndicate or group that would be deemed to be a person under Section 13(d)(3) of the Exchange Act.
- (d) “Code” shall mean the Commercial Code of California, as amended from time to time.
- (e) “Collateral” shall mean all of Borrower’s present and future right, title and interest in and to any and all of the personal property of Borrower whether such property is now existing or hereafter created, acquired or arising and wherever located from time to time, including without limitation:
 - (i) accounts;
 - (ii) chattel paper;
 - (iii) goods;
 - (iv) inventory;
 - (v) equipment;
 - (vi) fixtures
 - (vii) farm products;
 - (viii) instruments;
 - (ix) investment property;
 - (x) documents;
 - (xi) commercial tort claims;
 - (xii) deposit accounts;
 - (xiii) letter-of-credit rights;
 - (xiv) general intangibles;
 - (xv) supporting obligations; and
 - (xvi) records of, accession to and proceeds and products of the foregoing.
- (f) “Debtors” shall mean Borrower’s customers who are indebted to Borrower.
- (g) “Material Adverse Change” means (i) a material adverse change in the business, operations, results of operations, assets, liabilities, or condition of Borrower and its subsidiaries taken as a whole, (ii) the impairment of Borrower’s ability to perform any of the Obligations or of the Bank to enforce the Indebtedness or realize upon the Collateral, or (iii) a material adverse change in the value of the Collateral or the amount which the Bank would be likely to receive in the liquidation of the Collateral.

(h) "Obligations" shall mean, without limitation, all loans, advances, indebtedness, notes, liabilities and amounts (including under Letters of Credit), liquidated or unliquidated, owing by Borrower to Bank or any Bank Affiliate at any time, of each and every kind, nature and description, whether arising under this Agreement or otherwise, and whether secured or unsecured, direct or indirect (that is, whether the same are due directly by Borrower to Bank or any Bank Affiliate; or are due indirectly by Borrower to Bank or any Bank Affiliate as endorser, guarantor or other surety, or as borrower of obligations due third persons which have been endorsed or assigned to Bank or any Bank Affiliate, or otherwise), absolute or contingent, due or to become due, now existing or hereafter arising or contracted, including without limitation payment when due of all amounts outstanding respecting any of the Loan Documents. "Obligations" shall also include all interest and other charges chargeable to Borrower or due from Borrower to Bank or any Bank Affiliate from time to time and all costs and expenses referred to in this Agreement.

(i) "Permitted Indebtedness" shall mean (a) Borrower's indebtedness to Bank under this Agreement or any other Loan Document; (b) indebtedness existing on the date hereof in a principal amount not in excess of \$125,000; (c) indebtedness subordinated to the Obligations pursuant to an agreement in form and substance acceptable to Bank in its good faith business judgment; (d) indebtedness incurred as a result of endorsing negotiable instruments received in the ordinary course of business; (e) capitalized leases and purchase money Indebtedness secured by Permitted Liens in an aggregate amount not exceeding \$250,000 at any time outstanding; (f) indebtedness arising in connection with the financing of insurance premiums in the ordinary course of business; (g) indebtedness owing to trade creditors arising in the ordinary course of business consistent with past business practices; (h) indebtedness arising in connection with corporate credit cards issued for employees and officers of Borrower in an aggregate amount not to exceed \$50,000 at any time; and (i) extensions, refinancings, modifications, amendments and restatements of any items of Permitted Indebtedness, *provided*, that the principal amount thereof is not increased and the terms thereof are not modified to impose more burdensome terms upon Borrower.

(j) "Permitted Investments" shall mean, so long as no Event of Default shall have occurred and be continuing at the time of such investments or immediately after as a result of such investments, (a) investments in subsidiaries that are secured guarantors in an aggregate amount not to exceed \$500,000 in any fiscal year, *provided*, that no such investment shall be made if an Event of Default is then occurring or would otherwise arise upon the making thereof; (ii) repurchases of stock of Borrower of up to \$100,000 per fiscal year from departing employees, officers or directors; (iii) purchases of shares of Borrower's common stock pursuant to any stock repurchase program approved by the Board of Directors of Borrower to repurchase in the market any of its stock during the original term of the Revolving Loan (not including any extension or renewal periods), which repurchased stock shall have an aggregate purchase price of no more than \$1,000,000 in any fiscal year and no more than a total of \$2,000,000 during the entire original term of the Revolving Loan; *provided*, that no proceeds from the Revolving Loan shall be used for any such repurchases and, *provided, further*, that Bank may elect, in its sole discretion to extend the period of such permitted repurchases for any renewal or extension periods of the Revolving Loan on terms acceptable to Bank; (iv) investments (including debt obligations) received in connection with the bankruptcy or reorganization of customers or suppliers and in settlement of delinquent obligations of, and other disputes with, customers or suppliers arising in the ordinary course of Borrower's business; (v) investments existing on the date hereof as disclosed on Schedule PI attached hereto; and (vi) (A) marketable direct obligations issued or unconditionally guaranteed by the United States of America or any agency or any state thereof maturing within one (1) year from the date of acquisition thereof, (B) commercial paper maturing no more than one year from the date of creation thereof and currently having rating of at least A-2 or P-2 from either Standard & Poor's Corporation or Moody's Investors Service, (C) Bank's certificates of deposit maturing no more than one year from the date of investment therein, and (D) a money market account with Bank, provided that in each of the cases set forth in this clause (vi) Bank is perfected therein.

(k) "Permitted Liens" shall mean (i) liens and security interests securing indebtedness owed by Borrower to Bank; (ii) liens for taxes, assessments or similar charges either not yet due or being contested in good faith; (iii) liens of materialmen, mechanics, warehousemen or carriers, or other like liens arising in the ordinary course of business and securing obligations which are not yet delinquent or are being contested in good faith by appropriate proceedings; (iv) purchase money liens or purchase money security interest upon or in any property acquired or held by Borrower in the ordinary course of business to secure indebtedness outstanding on the date of this Agreement or permitted to be incurred under this Agreement; (v) liens and security interests which as of the date of this Agreement, have been disclosed to

and approved by the Bank in writing; (vi) liens which constitute banker's liens, rights of set-off or similar rights as to deposit accounts or other funds maintained with a bank or other financial institution; (vii) cash deposits or pledges to secure the payment of worker's compensation, unemployment insurance or other social security benefits or obligations, public or statutory obligations, surety or appeal bonds, bid or performance bonds or other obligations of a like nature incurred in the ordinary course of business; (viii) liens arising from judgments, decrees or attachments that do not result in an Event of Default; (ix) liens in favor of customs and revenue authorities arising the ordinary course of business relating to obligations that are not delinquent; and (x) liens incurred in connection with the extension, renewal or refinancing of the indebtedness secured by Permitted Liens described above, provided that any extension, renewal or replacement lien shall be limited to the property encumbered by the existing lien and the principal amount of the indebtedness being extended, renewed or refinanced shall not increase.

(I) "Person" or "party" shall mean individuals, partnerships, corporations, limited liability companies, trusts and all other entities.

All words and terms used in this Agreement other than those specifically defined herein shall have the meanings accorded to them in the Code.

2.3 Ordinary Course of Business. Bank hereby authorizes and permits Borrower to hold, process, sell, use or consume in the manufacture or processing of finished goods, or otherwise dispose of inventory for fair consideration, all in the ordinary course of Borrower's business, excluding, without limitation, sales to creditors or in bulk or sales or other dispositions occurring under circumstances which would or could reasonably be expected to create any lien or interest adverse to Bank's security interest or other right hereunder in the proceeds resulting therefrom. Bank also hereby authorizes and permits Borrower to receive from the Debtors all amounts due as proceeds of the Collateral at Borrower's own cost and expense, and also liability, if any, subject to the direction and control of Bank at all times; and Bank may at any time, without cause or notice, and whether or not an Event of Default has occurred or demand has been made, terminate all or any part of the authority and permission herein or elsewhere in this Agreement granted to Borrower with reference to the Collateral, and notify Debtors to make all payments due as proceeds of the Collateral to Bank. Until Bank shall otherwise notify Borrower, all proceeds of and collections of Collateral shall be retained by Borrower and used solely for the ordinary and usual operation of Borrower's business. From and after notice by Bank to Borrower, all proceeds of and collections of the Collateral shall be held in trust by Borrower for Bank and shall not be commingled with Borrower's other funds or deposited in any Bank account of Borrower; and Borrower agrees to deliver to Bank on the dates of receipt thereof by Borrower, duly endorsed to Bank or to bearer, or assigned to Bank, as may be appropriate, all proceeds of the Collateral in the identical form received by Borrower.

2.4 Allowances. Absent an Event of Default, Borrower may grant such allowances or other adjustments to Debtors (exclusive of extending the time for payment of any item which shall not be done without first obtaining Bank's written consent in each instance) as Borrower may reasonably deem to accord with sound business practice, including, without limiting the generality of the foregoing, accepting the return of all or any part of the inventory (subject to the provisions set forth in this Agreement with reference to returned inventory).

2.5 Records. Borrower shall hold its books and records relating to the Collateral segregated from all Borrower's other books and records in a manner satisfactory to Bank; and shall deliver to Bank from time to time promptly at its request all invoices, original documents of title, contracts, chattel paper, instruments and any other writings relating thereto, and other evidence of performance of contracts, or evidence of shipment or delivery of the merchandise or of the rendering of services; and Borrower will deliver to Bank promptly at Bank's request from time to time additional copies of any or all of such papers or writings, and such other information with respect to any of the Collateral and such schedules of inventory, schedules of accounts and such other writings as Bank may in its sole discretion deem to be necessary or effectual to evidence any loan hereunder or Bank's security interest in the Collateral.

2.6 Legends. Borrower shall promptly make, stamp or record such entries or legends on Borrower's books and records or on any of the Collateral (including without limitation chattel paper) as Bank shall request from time to time, to indicate and disclose that Bank has a security interest in such Collateral.

2.7 Inspection. Bank, or its representatives, at any time and from time to time, shall have the right at the sole cost and expense of Borrower, and Borrower will permit Bank and/or its representatives: (a) to examine, check, make copies of or extracts from any of Borrower's books, records and files (including without limitation orders and original correspondence); (b) to perform field exams or otherwise inspect and examine the Collateral and to check, test or appraise the same as to quality, quantity, value and condition; and (c) to verify the Collateral or any portion or portions thereof or Borrower's compliance with the provisions of this Agreement. Unless an Event of Default shall have occurred and be continuing, Bank agrees to conduct not more than one inspection as described herein during each fiscal year of Borrower.

2.8 Purchase Money Security Interests. To the extent Borrower uses proceeds of any loans to purchase Collateral, the repayment of such loans shall be on a "first-in-first-out" basis so that the portion of the loan used to purchase a particular item of Collateral shall be repaid in the order in which Borrower purchased such item of Collateral.

2.9 Search Reports. Bank shall receive prior to the date of this Agreement UCC search results under all names used by Borrower during the prior five (5) years, from each jurisdiction where any Collateral is located, from the state, if any, where Borrower is organized and registered (as such terms are used in the Code), and the state where Borrower's chief executive office is located. The search results shall confirm that the security interest in the Collateral granted Bank hereunder is prior to all other security interests in favor of any other person.

3. REPRESENTATIONS AND WARRANTIES

3.1 Organization and Qualification. Borrower is a duly organized and validly existing corporation under the laws of the state of its incorporation with the exact legal name set forth in the first paragraph of this Agreement. Borrower is in good standing under the laws of said state, has the power to own its property and conduct its business as now conducted and as currently proposed to be conducted, and is duly qualified to do business under the laws of each state where the nature of the business done or property owned requires such qualification.

3.2 Subsidiaries. Borrower has no subsidiaries other than those listed on Schedule 3.2, if any, and Borrower has never consolidated, merged or acquired substantially all of the assets of any other entity or person other than those listed on Schedule 3.2, if any.

3.3 Corporate Records. Borrower's charter, articles or certificate of organization or incorporation and all amendments thereto have been duly filed and are in proper order. All outstanding capital stock issued by Borrower was and is properly and validly issued, fully paid and nonassessable and all books and records of Borrower, including but not limited to its minute books, bylaws and books of account, are accurate and up to date and will be so maintained.

3.4 Title to Properties; Absence of Liens. Borrower has good and clear record, equitable and marketable title to all of its properties and assets, including without limitation to all of the Collateral, free and clear of all mortgages, liens, pledges, charges, encumbrances and setoffs, other than (a) the security interest therein granted to Bank, (b) the mortgages, deeds of trust and security interests as set forth on Schedule 3.4, if any, (c) the leases of personal property as set forth on Schedule 3.4, if any, and (d) any other Permitted Liens.

3.5 Places of Business. Borrower's chief executive office is correctly stated in the preamble to this Agreement, and Borrower shall, during the term of this Agreement, keep Bank currently and accurately informed in writing of each of its other places of business, and shall not change the location of such chief executive office or open or close, move or change any existing or new place of business without giving Bank at least thirty (30) days prior written notice thereof.

3.6 Valid Obligations. The execution, delivery and performance of the Loan Documents have been duly authorized by all necessary corporate action and each represents a legal, valid and binding obligation of Borrower and is fully enforceable according to its terms, except as limited by laws relating to the enforcement of creditors' rights.

3.7 Conflicts. There is no provision in Borrower's organizational or charter documents, if any, or in any indenture, contract or agreement to which Borrower is a party or by which it or any of its assets or properties are bound which prohibits, limits or restricts the execution, delivery or performance of the Loan Documents.

3.8 Governmental Approvals. The execution, delivery and performance of the Loan Documents do not require any approval of or filing with any governmental agency or authority.

3.9 Litigation, etc. There are no actions, claims or proceedings pending or, to the knowledge of Borrower, threatened against Borrower which could reasonably be expected to result in a Material Adverse Change.

3.10 Accounts and Contract Rights. All accounts arise out of legally enforceable and existing contracts, and represent unconditional and undisputed bona fide indebtedness by a Debtor, and are not and will not be subject to any discount (except such cash or trade discount as may be shown on any invoice, contract or other writing delivered to Bank). No contract right, account, general intangible or chattel paper is or will be represented by any note or other instrument, and no contract right, account or general intangible is, or will be represented by any conditional or installment sales obligation or other chattel paper, except such instruments or chattel paper as have been or immediately upon receipt by Borrower will be delivered to Bank (duly endorsed or assigned), such delivery, in the case of chattel paper, to include all executed copies except those in the possession of the installment buyer and any security for or guaranty of any of the Collateral shall be delivered to Bank immediately upon receipt thereof by Borrower, with such assignments and endorsements thereof as Bank may request.

3.11 Title to Collateral. At the date hereof, Borrower is (and, as to Collateral that Borrower may acquire after the date hereof, will be) the lawful owner of the Collateral, and the Collateral and each item thereof is, will and shall continue to be free of all restrictions, liens, encumbrances or other rights, title or interests (other than the security interest therein granted to Bank), credits, defenses, recoupments, set-offs or counterclaims whatsoever. Borrower has and will have full power and authority to grant to Bank a security interest in the Collateral and Borrower has not transferred, assigned, sold, pledged, encumbered, subjected to lien or granted any security interest in, and will not transfer, assign, sell (except sales or other dispositions in the ordinary course of business in respect to inventory as expressly permitted in this Agreement), pledge, encumber, subject to lien or grant any security interest in any of the Collateral (or any of Borrower's right, title or interest therein), to any person other than Bank or as expressly permitted hereunder, including in connection with any Permitted Liens. The Collateral is and will be valid and genuine in all respects. Borrower will warrant and defend Bank's right to and interest in the Collateral against all claims and demands of all persons whatsoever, except to the extent such claims or demands arise from any Permitted Liens.

3.12 Location of Collateral. Except for sale, processing, use, consumption or other disposition in the ordinary course of business, Borrower will keep all inventory and equipment only at locations specified in this Agreement or specified to Bank in writing.

3.13 Third Parties. Bank shall not be deemed to have assumed any liability or responsibility to Borrower or any third person for the correctness, validity or genuineness of any instruments or documents that may be released or endorsed to Borrower by Bank (which shall automatically be deemed to be without recourse to Bank in any event) or for the existence, character, quantity, quality, condition, value or delivery of any goods purporting to be represented by any such documents; and Bank, by accepting such security interest in the Collateral, or by releasing any Collateral to Borrower, shall not be deemed to have assumed any obligation or liability to any supplier or Debtor or to any other third party, and Borrower agrees to indemnify and defend Bank and hold it harmless in respect to any claim or proceeding arising out of any matter referred to in this paragraph.

3.14 Status of Debtors. Borrower agrees to notify Bank promptly upon learning of (a) the suspension of business, assignment or trust mortgage for the benefit of creditors, dissolution, petition in receivership or under any chapter of the Bankruptcy Code, as amended from time to time, by or against any Debtor, (b) any Debtor's insolvency or inability to pay its debts as they mature or (c) any other act of the same or different nature amounting to a Debtor's business failure.

3.15 Taxes. Borrower has filed all federal, state and other tax returns required to be filed (except for such returns for which current and valid extensions have been filed), and all taxes, assessments and other governmental charges due from Borrower have been fully paid. Borrower has established on its books reserves adequate for the payment of all federal, state and other tax liabilities, if any.

3.16 Use of Proceeds. No portion of any loan is to be used for (i) the purpose of purchasing or carrying any "margin security" or "margin stock" as such terms are used in Regulations U and X of the Board of Governors of the Federal Reserve System, 12 C.F.R. 221 and 224 or for any other purpose in violation of such Regulations U or X (ii) primarily personal, family or household purposes. The Collateral is not used or acquired primarily for personal, family or household purposes.

3.17 Licenses, Consents. Borrower has obtained and holds in full force and effect all filings, registrations, franchises, licenses, permits, certificates, authorizations, qualifications, accreditations, easements, rights of way and other rights, consents and approvals which are necessary for the operation of its businesses as presently conducted or proposed to be conducted and the failure of which to maintain could reasonably be expected to result in a Material Adverse Change. No consent or approval, authorization or order of, or registration or filing with, or giving of notice to, or obtaining of any license, certificate or permit from, or taking any other action with respect to any third party is required to be obtained or provided in connection with (i) the due execution, delivery and performance of any Loan Document or the consummation of any of the transactions contemplated hereunder, (ii) the legality, validity, binding effect or enforceability of any Loan Document on Borrower and the exercise by Bank of its rights and remedies thereunder, (iii) the grant of any liens or security interests by Borrower to Bank and the validity, perfection and priority of such liens or security interests, or (v) the conduct by Borrower or any of its affiliates of any of their business as proposed to be conducted.

3.18 Financial Statement Certifications. Borrower hereby certifies to Bank that all financial information ("financial information") submitted to Bank now and at all times during the term of the Loan does and will fairly and accurately represent the financial condition of Borrower and any of its Affiliates. Financial information includes, but is not limited to, all business financial statements (including interim and year-end financial statements that are company prepared and/or CPA prepared), business income tax returns, borrowing base certificates, accounts payable and receivable agings, financial statements and tax returns. Borrower understands that Bank will rely on all financial information, whenever provided, and that such information is a material inducement to Bank to make, to continue to make, or otherwise extend credit accommodations to Borrower. Borrower covenants and agrees to notify Bank in writing of any Material Adverse Change. Borrower further understands and acknowledges that there are criminal penalties for giving false financial information to federally insured financial institutions.

3.19 Environmental. As of the date hereof, neither Borrower nor any of Borrower's agents, employees or independent contractors (1) have caused or are aware of a release or threat of release of Hazardous Materials on any of the premises or personal property owned or controlled by Borrower ("Controlled Property") or any property abutting Controlled Property ("Abutting Property"), which could give rise to liability under any Environmental Law or any other federal, state or local law, rule or regulation; (2) have arranged for the transport of or transported any Hazardous Materials in a manner as to violate, or result in potential liabilities under, any Environmental Law; (3) have received any notice, order or demand from the Environmental Protection Agency or any other federal, state or local agency under any Environmental Law; (4) have incurred any liability under any Environmental Law in connection with the mismanagement, improper disposal or release of Hazardous Materials; or (5) are aware of any inspection or investigation of any Controlled Property or Abutting Property by any federal, state or local agency for possible violations of any Environmental Law.

To the best of Borrower's knowledge, neither Borrower, nor any prior owner, tenant or other occupant of any Controlled Property, committed or omitted any act which caused the release of Hazardous Materials on such Controlled Property which could give rise to a lien thereon by any federal, state or local government. No notice or statement of claim or lien affecting any Controlled Property has been recorded or filed in any public records by any federal, state or local government for costs, penalties, fines or other charges as to such property. All notices, permits, licenses or similar authorizations, if any, required to be obtained or filed in connection with the ownership, operation, or use of the Controlled Property, including without limitation the past or present generation, treatment, storage, disposal or release of any Hazardous Materials into the environment, have been duly obtained or filed.

Borrower agrees to indemnify and hold Bank and any Bank Affiliate harmless from all liability, loss, cost, damage and expense, including attorney fees and costs of litigation, arising from any and all of its violations of any Environmental Law (including those arising from any lien by any federal, state or local government arising from the presence of Hazardous Materials) or from the presence of Hazardous Materials located on or emanating from any Controlled Property or Abutting Property whether existing or not existing and whether known or unknown at the time of the execution hereof and regardless of whether or not caused by, or within the control of Borrower. Borrower further agrees to reimburse Bank upon demand for any costs incurred by Bank in connection with the foregoing. Borrower agrees that its obligations hereunder shall be continuous and shall survive the repayment of all debts to Bank and shall continue so long as a valid claim may be lawfully asserted against Bank.

The term "Hazardous Materials" includes but is not limited to any and all substances (whether solid, liquid or gas) defined, listed, or otherwise classified as pollutants, hazardous wastes, hazardous substances, hazardous materials, extremely hazardous wastes, or words of similar meaning or regulatory effect under any present or future Environmental Law or that may have a negative impact on human health or the environment, including but not limited to petroleum and petroleum products, asbestos and asbestos-containing materials, polychlorinated biphenyls, lead, radon, radioactive materials, flammables and explosives.

The term "Environmental Law" means any present and future federal, state and local laws, statutes, ordinances, rules, regulations and the like, as well as common law, relating to protection of human health or the environment, relating to Hazardous Materials, relating to liability for or costs of remediation or prevention of releases of Hazardous Materials or relating to liability for or costs of other actual or threatened danger to human health or the environment. The term "Environmental Law" includes, but is not limited to, the following statutes, as amended, any successor thereto, and any regulations promulgated pursuant thereto, and any state or local statutes, ordinances, rules, regulations and the like addressing similar issues: the Comprehensive Environmental Response, Compensation and Liability Act; the Emergency Planning and Community Right-to-Know Act; the Hazardous Materials Transportation Act; the Resource Conservation and Recovery Act (including but not limited to Subtitle I relating to underground storage tanks); the Solid Waste Disposal Act; the Clean Water Act; the Clean Air Act; the Toxic Substances Control Act; the Safe Drinking Water Act; the Occupational Safety and Health Act; the Federal Water Pollution Control Act; the Federal Insecticide, Fungicide and Rodenticide Act; the Endangered Species Act; the National Environmental Policy Act; and the River and Harbors Appropriation Act.

4. AFFIRMATIVE COVENANTS

4.1 Payments and Performance. Borrower will duly and punctually pay all Obligations becoming due to Bank and will duly and punctually perform all Obligations on its part to be done or performed under this Agreement.

4.2 Books and Records; Inspection. Borrower will at all times keep proper books of account in which full, true and correct entries will be made of its transactions in accordance with generally accepted accounting principles, consistently applied and which are, in the opinion of a Certified Public Accountant acceptable to Bank, adequate to determine fairly the financial condition and the results of operations of Borrower. Borrower will from time to time furnish Bank with such information and statements as Bank may request in its sole discretion with respect to the Obligations or Bank's security interest in the Collateral. Borrower shall, during the term of this Agreement, keep Bank currently and accurately informed in writing of each location where Borrower's records relating to its accounts and contract rights are kept, and shall not remove such records to another location without giving Bank at least thirty (30) days prior written notice thereof.

4.3 Financial Statements. Borrower will furnish to Bank:

- (a) as soon as available to Borrower, but in any event within 30 days after the close of each fiscal quarter of Borrower, a full and complete signed copy of financial statements, which shall include a balance sheet of Borrower as at the end of such quarter and statement of profit and loss of Borrower reflecting the results of its operations during such quarter and shall be prepared by Borrower and certified by Borrower's chief financial officer as to correctness in accordance with generally accepted accounting principles, consistently applied, subject to year-end adjustments;
- (b) as soon as available to Borrower, but in any event within 90 days after the close of each fiscal year, a full and complete signed copy of financial statements, prepared by certified public accountants acceptable to Bank, which shall include a balance sheet of Borrower, as at the end of such year, statement of cash flows and statement of profit and loss of Borrower reflecting the results of its operations during such year, bearing the opinion of such certified public accountants and prepared on an audited basis in accordance with generally accepted accounting principles, consistently applied together with any so-called management letters;
- (c) within 30 days after the close of each quarter, an accounts receivable aging report in form satisfactory to Bank showing the total amount due from each Debtor, the month in which each account receivable was created, as well as an accounts payable aging report and such other information as Bank shall request;
- (d) within 30 days after the close of each fiscal quarter of Borrower, an inventory report in form satisfactory to Bank showing a list of Borrower's inventory, location of such inventory and such other information as Bank shall request;
- (e) within 30 days after the close of each fiscal quarter of Borrower, a work-in-progress/backlog report in form satisfactory to Bank and including such information as Bank shall request.
- (f) Borrower's filed federal and state tax returns, including all schedules thereto, for the prior year within 15 days after the date that Borrower's tax returns are actually filed each year or by such other date approved by Bank;
- (g) from time to time, such other financial data and information about Borrower as Bank may reasonably request.

4.4 Conduct of Business. Borrower will maintain its existence in good standing and comply with all laws and regulations of the United States and of any state or states thereof and of any political subdivision thereof, and of any governmental authority which may be applicable to it or to its business; except to the extent that non-compliance with such laws or regulations (a) pertains to any tax, assessment or charge which is being contested in good faith and with respect to which reserves have been established and are being maintained or (b) does not or could not reasonably be expected to result a Material Adverse Change.

4.5 Notice to Debtors. Borrower agrees, at the request of Bank, to notify all or any of the Debtors in writing of Bank's security interest in the Collateral in whatever manner Bank requests and hereby authorizes Bank to notify all or any of the Debtors of Bank's security interest in Borrower's accounts at Borrower's expense.

4.6 Contact with Accountant. Borrower hereby authorizes Bank to directly contact and obtain information from any accountant employed by Borrower in connection with the review or maintenance of Borrower's books and records or preparation of any financial reports delivered by or at the request of Borrower to Bank.

4.7 Operating and Deposit Accounts. Borrower shall maintain its primary operating and deposit accounts with Bank for so long as any indebtedness or other amounts remain due and outstanding by Borrower to Bank hereunder or Banks shall have a commitment to lend under any of the Loans. At the option of Bank, all loan payments and fees will automatically be debited from Borrower's primary operating account and all advances will automatically be credited to Borrower's primary operating account.

4.8 Taxes. Borrower will promptly pay all real and personal property taxes, assessments and charges and all franchise, income, unemployment, retirement benefits, withholding, sales and other taxes assessed against it or payable by it before delinquent; provided that this covenant shall not apply to any tax assessment or charge which is being contested in good faith and with respect to which reserves have been established and are being maintained. Bank may, at its option, from time to time, discharge any taxes, liens or encumbrances of any of the Collateral provided Bank gives notice to Borrower thereof, and Borrower will pay to Bank on demand or Bank in its sole discretion may charge to Borrower all amounts so paid or incurred by it.

4.9 Maintenance. Borrower will keep and maintain the Collateral and its other properties, if any, in good repair, working order and condition. Borrower will immediately notify Bank of any loss or damage to or any occurrence which would adversely affect the value of any Collateral. Bank may, at its option, from time to time, take any other action that Bank may deem proper to repair, maintain or preserve any of the Collateral provided Bank gives notice to Borrower thereof, and Borrower will pay to Bank on demand or Bank in its sole discretion may charge to Borrower all amounts so paid or incurred by it.

4.10 Insurance. Borrower will maintain in force property and casualty insurance on all Collateral and any other property of Borrower, if any, against risks customarily insured against by companies engaged in businesses similar to that of Borrower containing such terms and written by such companies as may be satisfactory to Bank, such insurance to be payable to Bank as its interest may appear in the event of loss and to name Bank as insured pursuant to a standard loss payee clause; no loss shall be adjusted thereunder without Bank's approval; and all such policies shall provide that they may not be canceled without first giving at least ten (10) days written notice of cancellation to Bank. In the event that Borrower fails to provide evidence of such insurance, Bank may, at its option, secure such insurance and charge the cost thereof to Borrower. Upon the occurrence and during the continuation of an Event of Default, at the option of Bank, all insurance proceeds received from any loss or damage to any of the Collateral shall be applied either to the replacement or repair thereof or as a payment on account of the Obligations.

4.11 Notification of Default. Immediately upon becoming aware of the existence of any condition or event which constitutes an Event of Default, or any condition or event which would upon notice or lapse of time, or both, constitute an Event of Default, Borrower shall give Bank written notice thereof specifying the nature and duration thereof and the action being or proposed to be taken with respect thereto.

4.12 Notification of Material Litigation. Borrower will immediately notify Bank in writing of any litigation or of any investigative proceedings of a governmental agency or authority commenced or threatened against it which would or might be materially adverse to the financial condition of Borrower.

4.13 USA PATRIOT Act. Borrower shall furnish or cause to be furnished to Bank, promptly upon request therefor, any information required by Bank under or in connection with the USA PATRIOT Act.

4.14 Pension Plans. With respect to any pension or benefit plan maintained by Borrower, or to which Borrower contributes ("Plan"), the benefits under which are guaranteed, in whole or in part, by the Pension Benefit Guaranty Corporation created by the Employee Retirement Income Security Act of 1974, P.L. 93-406, as amended ("ERISA") or any governmental authority succeeding to any or all of the functions of the Pension Benefit Guaranty Corporation ("Pension Benefit Guaranty Corporation"), Borrower will (a) fund each Plan as required by the provisions of Section 412 of the Internal Revenue Code of 1986, as amended; (b) cause each Plan to pay all benefits when due; (c) furnish Bank (i) promptly with a copy of any notice of each Plan's termination sent to the Pension Benefit Guaranty Corporation (ii) no later than the date of submission to the Department of Labor or to the Internal Revenue Service, as the case may be, a copy of any request for waiver from the funding standards or extension of the amortization periods required by Section 412 of the Internal Revenue Code of 1986, as amended and (iii) notice of any Reportable Event as such term is defined in ERISA; and (d) subscribe to any contingent liability insurance provided by the Pension Benefit Guaranty Corporation to protect against employer liability upon termination of a guaranteed pension plan, if available to Borrower.

4.15 Mid-Term Review. Borrower covenants and agrees that, on or around October 1, 2009, Bank may, in its sole discretion, review the terms and conditions relating to the interest rates and other pricing terms for the Loans and the financial and other covenants hereunder.

5. NEGATIVE COVENANTS

5.1 Financial Covenants. Borrower will not at any time or during any fiscal period (as applicable) fail to be in compliance with any of the financial covenants in this section.

(a) Definitions. The following definitions shall apply to this Section:

(i) "Current Assets" shall mean current assets as defined under GAAP.

(ii) "Current Liabilities" shall mean current liabilities as defined under GAAP.

(iii) "Earnings" shall mean earnings as defined under GAAP.

(iv) "EBITDA" shall mean, for any period, Earnings from continuing operations before payment of federal, state and local income taxes, plus interest expense, depreciation and amortization, in each case for such period, calculated in accordance with GAAP.

(v) "Funded Indebtedness" shall mean, as of the date of determination thereof, all short term and long term debt, including debentures, plus capital leases.

(vi) "GAAP" shall mean generally accepted accounting principles in effect from time to time in the United States.

(b) Current Ratio. Borrower shall maintain a ratio of Current Assets to Current Liabilities, measured as of the end of each fiscal quarter, of not less than of 1.25 to 1.00 until June 30, 2009 and, thereafter, of not less than 1.50 to 1.00.

(c) Maximum Funded Debt to EBITDA. Borrower shall not permit the ratio of its Funded Indebtedness to EBITDA to be greater than 2.500 to 1.00, measured as of the end of each fiscal quarter on a rolling four-quarter basis.

(d) Debt Service Coverage Ratio. Borrower shall maintain a Debt Service Coverage Ratio, measured as of the end of each fiscal quarter on a rolling four-quarter basis, of not less than 1.40 to 1.00 until March 30, 2010 and, thereafter, of not less than 1.50 to 1.00. "Debt Service Coverage Ratio" shall mean, for any period, (i) the sum of EBITDA and other non-cash expenses of Borrower for such period, less taxes paid, taxes accrued and payable and unfinanced capital expenses for such period, divided by (ii) the sum of current portion of long-term debt, current portion of long-term leases and interest paid, in each case for such period.

(e) Profitability. Borrower shall not have two consecutive quarters of net losses, measured as of the end of each fiscal quarter.

5.2 Limitations on Indebtedness. Borrower shall not issue any evidence of indebtedness or create, assume, guarantee, become contingently liable for or suffer to exist indebtedness in addition to indebtedness to Bank, except Permitted Indebtedness or indebtedness or liabilities of Borrower, other than for money borrowed, incurred or arising in the ordinary course of business.

5.3 Sale of Interest. There shall not be any sale or transfer of ownership of any interest in Borrower without Bank's prior written consent, unless such sale or transfer shall not result in a Change in Control.

5.4 Loans or Advances. Borrower shall not make any loans or advances to any Person, including without limitation its officers and employees; *provided, however,* that Borrower may make advances to its employees, including its officers, with respect to expenses incurred or to be incurred by such employees in the ordinary course of business which expenses are reimbursable by Borrower; and *provided, further,* that Borrower may extend credit in the ordinary course of business in accordance with customary trade practices.

5.5 Dividends and Distributions. Borrower shall not, without prior written consent of Bank, pay any dividends on or make any distribution on account of any class of such Borrower's capital stock in cash or in property (other than additional shares of such stock), or redeem, purchase or otherwise acquire, directly or indirectly, any of such stock, except to the extent such redemption, purchase or other acquisition constitutes a Permitted Investment or, with the prior written consent of Bank in each instance and so long as such Borrower is not in default hereunder, distributions to the stockholders of such Borrower in such amounts as are necessary to pay the tax liability of such stockholders due as a result of such stockholders' interest in such Borrower or as otherwise approved by Bank in its sole discretion.

5.6 Investments. Borrower shall not make investments in, or advances to, any Person, except for Permitted Investments. Borrower will not purchase or otherwise invest in or hold securities, non-operating real estate or other non-operating assets or purchase all or substantially all the assets of any entity, except for Permitted Investments.

5.7 Merger. Borrower will not merge or consolidate or be merged or consolidated with or into any other entity, unless Borrower is the surviving entity and such merger or consolidation does not result in a Change in Control.

5.8 Capital Expenditures. Borrower shall not, directly or indirectly, make or commit to make capital expenditures by lease, purchase or otherwise, except (a) in the ordinary and usual course of business up to an aggregate limit of \$1,000,000.00 or (b) with Bank's prior written consent.

5.9 Sale of Assets. Borrower shall not sell, lease or otherwise dispose of any of its assets, except in the ordinary and usual course of business and except for the purpose of replacing machinery, equipment or other personal property which, as a consequence of wear, duplication or obsolescence, is no longer used or necessary in Borrower's business, *provided*, that fair consideration is received therefor.

5.10 Restriction on Liens. Borrower shall not encumber or grant any security interest or lien on or in or mortgage of any of its properties or assets, including without limitation the Collateral, except for Permitted Liens. Borrower shall not enter into any agreement with any person other than Bank that prohibits Borrower from granting any security interest in, or mortgage of, any of its properties or assets including the Collateral.

5.11 Other Business. Borrower shall not engage in any business other than the business in which it is currently engaged or a business reasonably allied thereto.

5.12 Change of Name, etc. Borrower shall not change its legal name or the state or the type of its organization, without giving Bank at least 30 days' prior written notice thereof.

6. STAND-BY LETTERS OF CREDIT SUBLINE

The Revolving Loan shall include a subline facility (the "Stand-By Letter of Credit Subline") for stand-by letters of credit (each, a "Stand-By Letter of Credit" and, collectively, "Stand-By Letters of Credit") for the account of Borrower. So long as there is no Event of Default and subject to the terms and conditions of this Agreement, Borrower may obtain Stand-By Letters of Credit from Bank on a revolving basis. The Stand-By Letter of Credit Subline may be used for obtaining Stand-By Letters of Credit with a maximum expiration date of October 1, 2010.

(a) The amount of all issued, outstanding and unexpired Stand-By Letters of Credit, including amounts drawn on Stand-By Letters of Credit and not yet reimbursed by Borrower to Bank, may not exceed \$1,500,000.00.

(b) The amount of all issued, outstanding and unexpired Stand-By Letters of Credit, including amounts drawn on Stand-By Letters of Credit and not yet reimbursed to Bank, together with all other amounts outstanding under the Revolving Loan, shall not exceed \$12,000,000.00.

(c) Any sum drawn under a Stand-By Letter of Credit shall, at Borrower's election, either be immediately reimbursed to Bank by Borrower or added to the principal amount outstanding under the Revolving Loan and shall be governed by the terms and conditions regarding the Revolving Loan set forth in this Agreement. Any sum drawn under a Stand-By Letter of Credit after the maturity of the Revolving Loan or after the occurrence of an Event of Default shall be due with interest on demand and shall accrue interest at the default rate of interest as provided in this Agreement.

(d) In the event any Stand-By Letters of Credit are outstanding on October 1, 2010, or upon the occurrence of an Event of Default, Borrower shall immediately provide Bank with a written request for cancellation of the Stand-By Letter of Credit from the beneficiary's bank in form acceptable to Bank or deposit with Bank, as cash collateral for the obligations of Borrower to reimburse Bank for draws under such remaining outstanding Stand-By Letters of Credit, an amount equal to the face amount of all such outstanding Stand-By Letters of Credit to be applied to repay draws under such Stand-By Letters of Credit as and when made. Borrower hereby grants to Bank a security interest in such cash collateral.

(e) The issuance of any Stand-By Letter of Credit or any amendment to a Stand-By Letter of Credit is subject to Bank's written approval and such Stand-By Letter of Credit, or any amendment thereto, must be in form and content satisfactory to Bank and in favor of a beneficiary acceptable to Bank. Borrower will complete with proper insertions, sign and deliver to Bank, Bank's application and agreement for each requested Stand-By Letter of Credit. Bank may refuse to issue a Stand-By Letter of Credit or amendment to any Stand-By Letter of Credit due to the nature or terms of the transaction for which the Stand-By Letter of Credit is required or when applicable law, regulation or order prohibits the issuance of the Stand-By Letter of Credit or amendment.

(f) Borrower agrees that Bank may automatically charge Borrower's deposit accounts with Bank for applicable fees, discounts and other charges relating to any Stand-By Letters of Credit, as well as for any reimbursement obligation hereunder, and Borrower grants a security interest to Bank in any such accounts for such purposes.

(g) Borrower will pay promptly Bank's issuance, settlement and other fees (in accordance with the prevailing California Bank & Trust Transaction Fee Schedule as issued from time to time or such other current Bank publication) for Stand-By Letters of Credit and all expenses incurred by Bank in connection therewith.

(h) Bank shall have no obligation to enter a Stand-By Letter of Credit if there is an uncured breach of Event of Default by Borrower under this Agreement, any Stand-By Letter of Credit or any other Obligation of Borrower to Bank.

7. DEFAULT

7.1 Default. "Event of Default" shall mean the occurrence of one or more of any of the following events:

(a) failure to pay in full any installment of principal or interest under the Note or any fee or other amount due and payable under the Loan Documents or a default by Borrower with respect to any covenant set forth in Section 5 herein or any other negative covenant under the Loan Documents;

(b) default or failure by Borrower to perform any covenant set forth in Section 4 herein or any other term, liability, obligation, covenant or undertaking of Borrower hereunder or under any of the other the Loan Documents (other than any default or failure described in Section 7.1(a)) and such default or failure shall continue for fifteen (15) days after Borrower becomes aware of such default or failure or Bank gives Borrower written notice of such default or failure, whichever occurs first, or, if such default or failure is of a nature that it is not reasonably capable of being cured within such 15-day period, Borrower shall have commenced the cure within such 15-day period and shall diligently pursue such cure until completion, which shall not exceed sixty (60) days after the cure has commenced;

(c) failure of Borrower to maintain aggregate Collateral value to the extent such failure results in a Material Adverse Change;

- (d) an event of default of any material liability, obligation or undertaking of Borrower to any other party;
- (e) if any statement, representation or warranty heretofore, now or hereafter made by Borrower in connection with this Agreement or in any supporting financial statement of Borrower shall be determined by Bank to have been false or misleading in any material respect when made;
- (f) (i) the liquidation, termination or dissolution of Borrower, (ii) the merger or consolidation of Borrower into another entity, or the sale or transfer of any ownership interest in Borrower, resulting in a Change in Control, (iii) Borrower's ceasing to carry on actively its present business or (iv) the appointment of a receiver for its property;
- (g) the institution by or against Borrower of any proceedings under the United States Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.*, or any other law in which Borrower is alleged to be insolvent or unable to pay its debts as they mature, or the making by Borrower of an assignment for the benefit of creditors or the granting by Borrower of a trust mortgage for the benefit of creditors;
- (h) a judgment or judgments for the payment of money in excess of \$50,000 shall be rendered against Borrower and any such judgment shall remain unsatisfied and in effect for any period of thirty (30) consecutive days without a stay of execution;
- (i) any levy, lien (including mechanics lien), seizure, attachment, execution or similar process shall be issued or levied on any of the property of Borrower in connection with any liability or claim in an amount equal to \$50,000.00 or more; or
- (j) the occurrence of any change in the condition or affairs (financial or otherwise) of Borrower or the occurrence of any other event or circumstance resulting in a Material Adverse Change.

7.2 Acceleration. If an Event of Default shall occur, at the election of Bank, all Obligations shall become immediately due and payable without notice or demand, except with respect to Obligations payable on demand, which shall be due and payable on demand, whether or not an Event of Default has occurred. In addition, Bank may require that Borrower remit to Bank cash collateral in an amount equal to 110% of the aggregate undrawn amount of all outstanding Letters of Credit at such time, such cash collateral to be held by Bank in a cash collateral account on terms and conditions satisfactory to Bank.

Bank is hereby authorized, at its election, after an Event of Default or after demand, without any further demand or notice except to such extent as notice may be required by applicable law, to take possession and/or sell or otherwise dispose of all or any of the Collateral at public or private sale; and Bank may also exercise any and all other rights and remedies of a secured party under the Code or which are otherwise accorded to it in equity or at law, all as Bank may determine, and such exercise of rights in compliance with the requirements of law will not be considered adversely to affect the commercial reasonableness of any sale or other disposition of the Collateral. If notice of a sale or other action by Bank is required by applicable law, unless the Collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Borrower agrees that ten (10) days written notice to Borrower, or the shortest period of written notice permitted by such law, whichever is smaller, shall be sufficient notice; and that to the extent permitted by law, Bank, its officers, attorneys and agents may bid and become purchasers at any such sale, if public, and may purchase at any private sale any of the Collateral that is of a type customarily sold on a recognized market or which is the subject of widely distributed standard price quotations. Any sale (public or private) shall be without warranty and free from any right of redemption, which Borrower shall waive and release after default upon Bank's request therefor, and may be free of any warranties as to the Collateral if Bank shall so decide. No purchaser at any sale (public or private) shall be responsible for the application of the purchase money. Any balance of the net proceeds of sale remaining after paying all Obligations of Borrower to Bank shall be returned to such other party as may be legally entitled thereto; and if there is a deficiency, Borrower shall be responsible for repayment of the same, with interest. Upon demand by Bank, Borrower shall assemble the Collateral and make it available to Bank at a place designated by Bank which is reasonably convenient to Bank and Borrower. Borrower hereby acknowledges that Bank has extended credit and other financial accommodations to Borrower upon reliance of Borrower's granting Bank the rights and remedies contained in this Agreement including without limitation the right to take immediate possession of the Collateral upon the occurrence of an Event of Default or after demand with respect to Obligations payable on demand and Borrower hereby acknowledges that Bank is entitled to equitable and injunctive relief to enforce any of its rights and remedies hereunder or under the Code.

Bank shall not be required to marshal any present or future security for (including but not limited to this Agreement and the Collateral subject to the security interest created hereby), or guarantees of, the Obligations or any of them, or to resort to such security or guarantees in any particular order; and all of its rights hereunder and in respect of such securities and guaranties shall be cumulative and in addition to all other rights, however existing or arising. To the extent that it lawfully may do so, Borrower hereby agrees that it will not invoke and irrevocably waives the benefits of any law relating to the marshaling of collateral which might cause delay in or impede the enforcement of Bank's rights under this Agreement or under any other instrument evidencing any of the Obligations or under which any of the Obligations is outstanding or by which any of the Obligations is secured or guaranteed. Except as required by applicable law, Bank shall have no duty as to the collection or protection of the Collateral or any income thereon, nor as to the preservation of rights against prior parties, nor as to the preservation of any rights pertaining thereto beyond the safe custody thereof.

7.3 Power of Attorney. Borrower hereby irrevocably constitutes and appoints Bank as Borrower's true and lawful attorney, with full power of substitution, at the sole cost and expense of Borrower but for the sole benefit of Bank, upon the occurrence of an Event of Default or after demand with respect to Obligations payable on demand, to convert the Collateral into cash, including without limitation completing the manufacture or processing of work in process, and the sale (either public or private) of all or any portion or portions of the inventory and other Collateral; to enforce collection of the Collateral, either in its own name or in the name of Borrower, including without limitation executing releases or waivers, compromising or settling with any Debtors and prosecuting, defending, compromising or releasing any action relating to the Collateral; to receive, open and dispose of all mail addressed to Borrower and to take therefrom any remittances or proceeds of Collateral in which Bank has a security interest; to notify Post Office authorities to change the address for delivery of mail addressed to Borrower to such address as Bank shall designate; to endorse the name of Borrower in favor of Bank upon any and all checks, drafts, money orders, notes, acceptances or other instruments of the same or different nature; to sign and endorse the name of Borrower on and to receive as secured party any of the Collateral, any invoices, freight or express receipts, or bills of lading, storage receipts, warehouse receipts, or other documents of title of the same or different nature relating to the Collateral; to sign the name of Borrower on any notice of the Debtors or on verification of the Collateral; and to sign, if necessary, and file or record on behalf of Borrower any financing or other statement in order to perfect or protect Bank's security interest. Bank shall not be obliged to do any of the acts or exercise any of the powers hereinabove authorized, but if Bank elects to do any such act or exercise any such power, it shall not be accountable for more than it actually receives as a result of such exercise of power, and it shall not be responsible to Borrower except for its own gross negligence or willful misconduct. All powers conferred upon Bank by this Agreement, being coupled with an interest, shall be irrevocable so long as any Obligation of Borrower or any guarantor or surety to Bank shall remain unpaid or Bank is obligated under this Agreement to extend any credit to Borrower.

7.4 Nonexclusive Remedies. All of Bank's rights and remedies not only under the provisions of this Agreement but also under any other agreement or transaction shall be cumulative and not alternative or exclusive, and may be exercised by Bank at such time or times and in such order of preference as Bank in its sole discretion may determine.

7.5 Right of Setoff. In addition to any rights now or hereafter granted, and not by way of limitation of any such rights, upon the occurrence and during the continuance of any Event of Default, Bank is hereby authorized at anytime or from time to time, to the extent permitted by law, without presentment, demand, protest or other notice of any kind to Borrower or to any other Person, any such notice being hereby expressly waived, to set off and to appropriate and apply any and all deposits (general or special, time or demand, provisional or final) and any other indebtedness at any time held or owing by Bank (including by branches and agencies of Bank wherever located) to or for the credit or the account of Borrower against and on account of the Obligations of Borrower to Bank under this Agreement or under any of the other Loan Documents and all other claims of any nature or description arising out of or connected with this Agreement or any other Loan Document, irrespective of whether or not Bank shall have made any demand hereunder and although said Obligations, liabilities or claims, or any of them, shall be contingent or unmatured.

7.6 Reassignment to Borrower. Whenever Bank deems it desirable that any legal action be instituted with respect to any Collateral or that any other action be taken in any attempt to effectuate collection of any Collateral, Bank may reassign the item in question to Borrower (and if Bank shall execute any such reassignment, it shall automatically be deemed to be without recourse to Bank in any event) and require Borrower to proceed with such legal or other action at Borrower's sole liability, cost and expense, in which event all amounts collected by Borrower on such item shall nevertheless be subject to Bank's security interest.

8. MISCELLANEOUS

8.1 Waivers. Borrower waives notice of intent to accelerate, notice of acceleration, notice of nonpayment, demand, presentment, protest or notice of protest of the Obligations, and all other notices, consents to any renewals or extensions of time of payment thereof, and generally waives any and all suretyship defenses and defenses in the nature thereof.

8.2 [Reserved]

8.3 Severability. If any provision of this Agreement or portion of such provision or the application thereof to any person or circumstance shall to any extent be held invalid or unenforceable, the remainder of this Agreement (or the remainder of such provision) and the application thereof to other persons or circumstances shall not be affected thereby.

8.4 Deposit Collateral. Borrower hereby grants to Bank a continuing lien and security interest in any and all deposit accounts (including without limitation time, savings, checking and money market accounts and certificates of deposit) or other sums at any time credited by or due from Bank or any Bank Affiliate to Borrower and any cash, securities, instruments or other property of Borrower in the possession of Bank or any Bank Affiliate, whether for safekeeping or otherwise, or in transit to or from Bank or any Bank Affiliate (regardless of the reason Bank or Bank Affiliate had received the same or whether Bank or Bank Affiliate has conditionally released the same) as security for the full and punctual payment and performance of all of the liabilities and obligations of Borrower to Bank or any Bank Affiliate and such deposits and other sums may be applied against such liabilities and obligations of Borrower to Bank or any Bank Affiliate at any time, whether or not such are then due, whether or not demand has been made and whether or not other collateral is then available to Bank or any Bank Affiliate.

8.5 Indemnification. Borrower shall indemnify, defend and hold Bank and any Bank Affiliate and their directors, officers, employees, shareholders, agents, authorized representatives and attorneys (each an "Indemnitee") harmless from and against any and all loss, liability or damages of claim brought or threatened against any Indemnitee by Borrower, any guarantor or endorser of the Obligations, or any other person (as well as from reasonable attorneys' fees and expenses in connection therewith) on account of Bank's relationship with Borrower, or any guarantor or endorser of the Obligations (each of which may be defended, compromised, settled or pursued by Bank with counsel of Bank's election, but at the expense of Borrower), except for any claim arising solely out of the gross negligence or willful misconduct of Bank. The within indemnification shall survive the termination or expiration of this Agreement the payment of the Obligations, and/or any termination, release or discharge executed by Bank in favor of Borrower.

8.6 Costs and Expenses. Whether or not the transactions contemplated hereby are consummated, Borrower agrees to pay (i) all costs and expenses incurred by Bank in connection with or arising from the performance of due diligence, the syndication of the credit facilities contemplated hereby, the negotiation, preparation, execution, delivery, waiver or modification and administration of this Agreement, the other Loan Documents and any other documentation contemplated hereby, the making of loans hereunder, including without limitation the out-of-pocket costs and internally allocated charges of audit or field examinations of Bank in connection with the administration of this Agreement, and (ii) all costs and expenses incurred by Bank in the maintenance, enforcement or protection of the rights and remedies of

Bank in connection with this Agreement, the Note or the other Loan Documents or any of Borrower's obligations hereunder or thereunder or as a result of any transaction, action or non-action arising from any of the foregoing, including without limitation any and all such costs and expenses incurred or paid by Bank in defending Bank's security interest in or right or title to the Collateral or in collecting or enforcing, or attempting to collect or enforce, payment of the Obligations. Such costs and expenses shall include without limitation attorneys' fees and disbursements, court costs, litigation and other expenses. Payments for any costs and expenses described in this section shall be made on the date this Agreement is executed by Borrower and thereafter on demand by Bank. Borrower agrees that it shall indemnify Bank from and hold it harmless against any documentary taxes, assessments or charges made by any governmental authority by reason of the execution and delivery of this Agreement, the Note and any of the other Loan Documents or the issuance of any letters of credit. The obligations of Borrower under this section shall survive the termination of this Agreement, the payment of the loans and the expiration of any letters of credit issued hereunder.

8.7 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be an original, but all of which, taken together, shall constitute but one agreement.

8.8 Complete Agreement. This Agreement and the other Loan Documents constitute the entire agreement and understanding between and among the parties hereto relating to the subject matter hereof and supersedes all prior proposals, negotiations, agreements and understandings among the parties hereto with respect to such subject matter, including the Original Agreement and the related Promissory Notes, Commercial Security Agreement, Corporate Resolution to Borrow/Grant Collateral, Stand-By Letter of Credit Subline addendum and Disbursement Requests and Authorizations (together with any amendments, extensions or renewals executed and delivered in connection therewith) (collectively, the "Prior Loan Documents"). From and after the date of execution of this Agreement, the Prior Loan Documents shall be of no further force or effect. Without limiting the generality of the foregoing and for the avoidance of doubt only, Borrower acknowledges and agrees that the Agreement to Provide Insurance and Notice of Insurance Requirements, dated October 16, 2008, executed by Borrower remains in full force and effect as of the date hereof and that the statements set forth therein are true, correct and complete and Borrower is in compliance with any and all covenants, requirements and agreements set forth therein as of the date hereof.

8.9 Binding Effect of Agreement. This Agreement shall be binding upon and inure to the benefit of the respective heirs, executors, administrators, legal representatives, successors and assigns of the parties hereto, and shall remain in full force and effect (and Bank shall be entitled to rely thereon) until released in writing by Bank. Bank may transfer and assign this Agreement and any Revolving Credit and deliver the Collateral to the assignee, who shall thereupon have all of the rights of Bank; and Bank shall then be relieved and discharged of any responsibility or liability with respect to this Agreement, and any such Revolving Credit and the Collateral. Borrower may not assign or transfer any of its rights or obligations under this Agreement. Except as expressly provided herein or in the other Loan Documents, nothing, expressed or implied, is intended to confer upon any party, other than the parties hereto, any rights, remedies, obligations or liabilities under or by reason of this Agreement or the other Loan Documents.

8.10 Further Assurances. Borrower will from time to time execute and deliver to Bank such documents, and take or cause to be taken, all such other or further action, as Bank may request in order to effect and confirm or vest more securely in Bank all rights contemplated by this Agreement and the other Loan Documents (including without limitation to correct clerical errors) or to vest more fully in or assure to Bank the security interest in the Collateral granted to Bank by this Agreement or to comply with applicable statute or law and to facilitate the collection of the Collateral (including without limitation the execution of stock transfer orders and stock powers, endorsement of promissory notes and instruments and notifications to obligors on the Collateral). To the extent permitted by applicable law, Borrower authorizes Bank to file financing statements, continuation statements or amendments, and any such financing statements, continuation statements or amendments may be filed at any time in any jurisdiction. Bank may at any time and from time to time file financing statements, continuation statements and amendments thereto which contain any information required by the Code for the sufficiency or filing office acceptance of any financing statement, continuation statement or amendment, including whether Borrower is an organization, the type of organization and any organization identification number issued to

Borrower. Borrower agrees to furnish any such information to Bank promptly upon request. In addition, Borrower shall at any time and from time to time take such steps as Bank may reasonably request for Bank (i) to obtain an acknowledgment, in form and substance satisfactory to Bank, of any bailee having possession of any of the Collateral that the bailee holds such Collateral for Bank, (ii) to obtain "control" (as defined in the Code) of any Collateral comprised of deposit accounts, electronic chattel paper, letter of credit rights or investment property, with any agreements establishing control to be in form and substance satisfactory to Bank, and (iii) otherwise to insure the continued perfection and priority of Bank's security interest in any of the Collateral and the preservation of its rights therein. Borrower hereby constitutes Bank its attorney-in-fact to execute, if necessary, and file all filings required or so requested for the foregoing purposes, all acts of such attorney being hereby ratified and confirmed; and such power, being coupled with an interest, shall be irrevocable until this Agreement terminates in accordance with its terms, all Obligations are irrevocably paid in full and the Collateral is released.

8.11 Amendments and Waivers. This Agreement may be amended and Borrower may take any action herein prohibited, or omit to perform any act herein required to be performed by it, if Borrower shall obtain Bank's prior written consent to each such amendment, action or omission to act. No course of dealing and no delay or omission on the part of Bank in exercising any right hereunder shall operate as a waiver of such right or any other right and waiver on any one or more occasions shall not be construed as a bar to or waiver of any right or remedy of Bank on any future occasion.

8.12 Term of Agreement. This Agreement shall continue in full force and effect so long as any Obligations or obligation of Borrower to Bank shall be outstanding, or Bank shall have any obligation to extend any financial accommodation hereunder, and is supplementary to each and every other agreement between Borrower and Bank and shall not be so construed as to limit or otherwise derogate from any of the rights or remedies of Bank or any of the liabilities, obligations or undertakings of Borrower under any such agreement, nor shall any contemporaneous or subsequent agreement between Borrower and Bank be construed to limit or otherwise derogate from any of the rights or remedies of Bank or any of the liabilities, obligations or undertakings of Borrower hereunder, unless such other agreement specifically refers to this Agreement and expressly so provides.

8.13 Notices. Any notice under or pursuant to this Agreement shall be a signed writing or other authenticated record (within the meaning of Article 9 of the Code). Any notices under or pursuant to this Agreement shall be deemed duly received and effective if delivered in hand to any officer or agent of Borrower or Bank, or if mailed by registered or certified mail, return receipt requested, addressed to Borrower or Bank at the address set forth in this Agreement or as any party may from time to time designate by written notice to the other party.

8.14 Governing Law. This Agreement has been executed or completed and is to be performed in California, and it and all transactions hereunder or pursuant hereto shall be governed as to interpretation, validity, effect, rights, duties and remedies of the parties hereunder and in all other respects by the internal laws of California without regard to principles of conflict of laws.

8.15 Reproductions. This Agreement and all documents which have been or may be hereinafter furnished by Borrower to Bank may be reproduced by Bank by any photographic, photostatic, microfilm, xerographic or similar process, and any such reproduction shall be admissible in evidence as the original itself in any judicial or administrative proceeding (whether or not the original is in existence and whether or not such reproduction was made in the regular course of business).

8.16 Jurisdiction and Venue. Borrower irrevocably submits to the nonexclusive jurisdiction of any federal or state court sitting in California, over any suit, action or proceeding arising out of or relating to this Agreement. Borrower irrevocably waives, to the fullest extent it may effectively do so under applicable law, any objection it may now or hereafter have to the laying of the venue of any such suit, action or proceeding brought in any such court and any claim that the same has been brought in an inconvenient forum. Borrower hereby consents to any and all process which may be served in any such suit, action or proceeding, (i) by mailing a copy thereof by registered and certified mail, postage prepaid, return receipt requested, to Borrower's address shown in this Agreement or as notified to Bank and (ii) by serving the same upon Borrower in any other manner otherwise permitted by law, and agrees that such service shall in every respect be deemed effective service upon Borrower

8.17 Civil Code § 2822. In the event that, at any time, a surety is liable upon only a portion of Borrower's obligations under the Loan Documents and Borrower provides partial satisfaction of any such obligations, Borrower hereby waives any right it would otherwise have under Section 2822 of the California Civil Code to designate the portion of the obligations to be satisfied. The designation of the portion of the obligation to be satisfied shall, to the extent not expressly made by the terms of the Loan Documents, be made by Bank rather than Borrower

8.18 MUTUAL WAIVER OF RIGHT TO JURY TRIAL. SUBJECT TO SECTION 8.19 AND TO THE EXTENT THAT IN THE FUTURE SUCH WAIVERS ARE PERMITTED BY LAW IN THE MANNER PROVIDED IN SECTION 8.19(a), BORROWER AND BANK EACH HEREBY KNOWINGLY, VOLUNTARILY AND INTENTIONALLY, AND AFTER AN OPPORTUNITY TO CONSULT WITH LEGAL COUNSEL, (a) WAIVES ANY AND ALL RIGHTS TO A TRIAL BY JURY (a "Jury Trial Waiver") IN ANY ACTION OR PROCEEDING IN CONNECTION WITH THIS AGREEMENT OR THE LOAN DOCUMENTS, THE OBLIGATIONS OR ANY MATTERS CONTEMPLATED HEREBY OR DOCUMENTS EXECUTED IN CONNECTION HERewith AND (b) AGREES NOT TO SEEK TO CONSOLIDATE ANY SUCH ACTION OR PROCEEDING WITH ANY OTHER ACTION OR PROCEEDING IN WHICH A JURY TRIAL CAN NOT BE OR HAS NOT BEEN WAIVED.

8.19 Reference Provision.

(a) The parties prefer that any dispute between them be resolved in litigation subject to a Jury Trial Waiver as set forth in Section 8.18 herein, but the California Supreme Court has held that such pre-dispute jury trial waivers are unenforceable. This section will be applicable until: (i) the California Supreme Court holds that a pre-dispute jury trial waiver provision similar to that contained in Section 8.18 herein is valid or enforceable; or (ii) the California Legislature passes legislation and the governor of the State of California signs into law a statute authorizing pre-dispute jury trial waivers and as a result such waivers become enforceable.

(b) Other than (i) non-judicial foreclosure of security interests in real or personal property, (ii) the appointment of a receiver or (iii) the exercise of other provisional remedies (any of which may be initiated pursuant to applicable law), any controversy, dispute or claim (each, a "Claim") between the parties arising out of or relating to this Agreement or any other Loan Documents, will be resolved by a reference proceeding in California in accordance with the provisions of Sections 638, *at seq.*, of the California Code of Civil Procedure ("CCP"), or their successor sections, which shall constitute the exclusive remedy for the resolution of any Claim, including whether the Claim is subject to the reference proceeding. Except as otherwise provided in the Loan Documents, venue for the reference proceeding will be in the superior court or federal district court in the county or district where the real property, if any, is located or in a county or district where venue is otherwise appropriate under applicable law (the "Court").

(c) The referee shall be a retired judge or justice selected by mutual written agreement of the parties. If the parties do not agree, the referee shall be selected by the presiding judge of the Court (or his or her representative). A request for appointment of a referee may be heard on an *ex parte* or expedited basis, and the parties agree that irreparable harm would result if *ex parte* relief is not granted. The referee shall be appointed to sit with all the powers provided by law. Pending appointment of the referee, the Court has power to issue temporary or provisional remedies.

(d) The parties agree that time is of the essence in conducting the reference proceedings. Accordingly, the referee shall be requested, subject to change in the time periods specified herein for good cause shown, to (i) set the matter for a status and trial-setting conference within fifteen (15) days after the date of selection of the referee, (ii) If practicable, try all issues of law or fact within ninety (90) days after the date of the conference and (iii) report a statement of decision within twenty (20) days after the matter has been submitted for decision.

(e) The referee will have power to expand or limit the amount and duration of discovery. The referee may set or extend discovery deadlines or cutoffs for good cause, including a party's failure to provide requested discovery for any reason whatsoever. Unless otherwise ordered based upon good cause shown, no party shall be entitled to "priority" in conducting discovery, depositions may be taken by either party upon seven (7) days written notice, and all other discovery shall be responded to within fifteen (15) days after service. All disputes relating to discovery which cannot be resolved by the parties shall be submitted to the referee whose decision shall be final and binding.

(f) Except as expressly set forth in this Agreement, the referee shall determine the manner in which the reference proceeding is conducted including the time and place of hearings, the order of presentation of evidence, and all other questions that arise with respect to the course of the reference proceeding. All proceedings and hearings conducted before the referee, except for trial, shall be conducted without a court reporter, except that when any party so requests, a court reporter will be used at any hearing conducted before the referee, and the referee will be provided a courtesy copy of the transcript. The party making such a request shall have the obligation to arrange for and pay the court reporter. Subject to the referee's power to award costs to the prevailing party, the parties will equally share the cost of the referee and the court reporter at trial.

(g) The referee shall be required to determine all issues in accordance with existing case law and the statutory laws of the State of California. The rules of evidence applicable to proceedings at law in the State of California will be applicable to the reference proceeding. The referee shall be empowered to enter equitable as well as legal relief, provide all temporary or provisional remedies, enter equitable orders that will be binding on the parties and rule on any motion which would be authorized in a trial, including without limitation motions for summary judgment or summary adjudication. The referee shall issue a decision pursuant to CCP § 644 and the referee's decision shall be entered by the Court as a judgment or an order in the same manner as if the action had been tried by the Court. The final judgment or order entered by the Court is fully appealable as provided by law. The parties reserve the right to findings of fact, conclusions of laws, a written statement of decision, and the right to move for a new trial or a different judgment, which new trial, if granted, is also to be a reference proceeding under this provision.

(h) If the enabling legislation which provides for appointment of a referee is repealed (and no successor statute is enacted), any dispute between the parties that would otherwise be determined by reference procedure will be resolved and determined by arbitration. The arbitration will be conducted by a retired judge or justice, in accordance with the California Arbitration Act, CCP §§ 1280 - § 1294.2, as amended from time to time. The limitations with respect to discovery set forth above shall apply to any such arbitration proceeding.

(i) THE PARTIES RECOGNIZE AND AGREE THAT ALL DISPUTES RESOLVED UNDER THIS REFERENCE PROVISION WILL BE DECIDED BY A REFEREE AND NOT BY A JURY, AFTER CONSULTING (OR HAVING HAD THE OPPORTUNITY TO CONSULT) WITH COUNSEL OF THEIR OWN CHOICE, EACH PARTY KNOWINGLY AND VOLUNTARILY AND FOR THEIR MUTUAL BENEFIT AGREES THAT THIS REFERENCE PROVISION WILL APPLY TO ANY DISPUTE BETWEEN THEM WHICH ARISES OUT OF OR IS RELATED TO THIS AGREEMENT OR THE LOAN DOCUMENTS.

8.20 USA PATRIOT Act. Bank notifies Borrower that, pursuant to the requirements of the USA PATRIOT Act, it is required to obtain, verify and record information that identifies Borrower, which information includes the name and address of Borrower and other information that will allow Bank to identify Borrower in accordance with the USA PATRIOT Act.

8.21 Waiver of Damages. Borrower acknowledges and agrees that Bank has no fiduciary relationship with or fiduciary duty or obligation to Borrower arising out of or in connection with this Agreement or any other Loan Document and that the relationship between Bank and Borrower in connection therewith is solely that of debtor and creditor. To the extent permitted by applicable law, Borrower waives, and covenants and agrees it will not assert, any claims against Bank on any theory of liability for special, indirect, consequential or punitive damages (as opposed to direct or actual damages) arising from or in connection with this Agreement, any Loan Document, any agreement or instrument contemplated hereby or thereby or the transactions contemplated hereby or thereby.

8.22 Participations. Bank may, without the consent of Borrower, sell participations to one or more banks or other entities in all or a portion of its rights and obligations under this Agreement, including without limitation all or a portion of the Loans then issued, outstanding and owing to Bank and the Note. Bank may, in connection with any assignment or participation or proposed assignment or participation pursuant to this section, disclose to the proposed assignee or participant any information relating to Borrower furnished to Bank by or on behalf of Borrower, provided, that the proposed assignee or participant agrees to hold such information confidential to the same extent Bank must hold such information confidential.

8.23 Construction of Agreement. Defined terms in this Agreement (including any schedules, exhibits and attachments hereto) shall include in the singular number the plural and in the plural number the singular. Whenever the context may require, any pronoun shall include the corresponding masculine, feminine and neuter forms.

8.24 Confidentiality. Bank agrees to maintain the confidentiality of any and all proprietary, trade secret or confidential information provided to or received by Bank from Borrower that indicates it is confidential, including business plans and forecasts, non-public financial and other information, confidential or secret processes, formulae, devices and contractual information, customer lists and employee relation matters, provided that Bank may disclose such information to its officers, directors, employees, attorneys, accountants, Affiliates, participants, prospective participants, assignees and prospective assignees and such other persons to whom Bank shall at any time be required to make such disclosure in accordance with applicable law or in the performance of its obligations in connection with the Loans, and provided that the foregoing provisions shall not apply to disclosures made by Bank in its good faith business judgment in connection with the enforcement of its rights or remedies after an Event of Default or to disclosures of information that is or becomes generally available to the public other than as a result of a disclosure by Bank or that was received by Bank in good faith from a third party who is not bound by an obligation of confidentiality or otherwise prohibited from transmitting the information.

[Remainder of page intentionally left blank]

8.25 *Force Majeure*. Neither party hereto shall be required to perform, or shall be liable for any failure to perform, its obligations hereunder during any period in which such non-performance is caused by or arises from (i) war, national emergencies, hostilities or acts of terrorism, (ii) natural disasters, weather conditions, mechanical breakdowns or power failure, (iii) strikes, work stoppages, labor shortages or inability to procure labor, and (iv) causes beyond the control of the party unable to perform; and any loss, damage, cost or expense arising therefrom or in connection therewith shall be excluded under this Agreement.

Executed as of February 4, 2009

Borrower:

Iteris, Inc.,
a Delaware corporation

By: /s/ James S. Miele
James S. Miele, Chief Financial Officer
For Iteris, Inc.

By: /s/ Abbas Mohaddes
Abbas Mohaddes, Chief Executive Officer

Accepted:

California Bank & Trust,
a California banking corporation

By: /s/ Sergio Alfonso
Sergio Alfonso, Vice President

Schedule P1

Existing Permitted Investments

None

EXHIBIT A

Excess Cash Flow Recapture Certificate

The undersigned, being the duly appointed, qualified and acting Chief Financial Officer of Iteris, Inc. ("Borrower"), hereby certifies that the following calculation of the Excess Cash Flow Recapture Amount pursuant to Section 1.1(b)(ii) of that certain Amended and Restated Loan and Security Agreement, dated as of February 4, 2009 (the "Loan Agreement"), between Borrower and California Bank & Trust, a California banking corporation ("Bank"), is true, complete and correct for Borrower's fiscal year ended March 31, 20 , and that such amount is to be applied to the outstanding principal balance of the Company's indebtedness under the Loan Agreement.

For fiscal year ended March 31, 20 :

1.	EBITDA		\$	
2.	Less:		\$	
	a. Taxes			
	b. Lesser of (i) \$1,500,000 and (ii) capital expenditures			
	c. Interest paid			
	d. Current portion of long-term debt			
3.	Deductions from EBITDA		\$	
4.	Excess Cash Flow		\$	
5.	Recapture Amount (50% x Excess Cash Flow)		x 50% \$	
6.	Maximum Excess Cash Flow Recapture Amount		\$	500,000
7.	Excess Cash Flow Recapture Amount to be paid by Borrower and applied to balance of Loan for fiscal year			
	20 (lesser of lines 5 and 6)		\$	

Capitalized terms used but not otherwise defined herein shall have the respective meanings ascribed to them in the Loan Agreement.

IN WITNESS WHEREOF, the undersigned has executed and delivered this Excess Cash Flow Recapture Certificate as of March 31, 20 .

/s/ James S. Miele

James S. Miele, Chief Financial Officer
For Iteris, Inc.

AMENDED AND RESTATED REVOLVING NOTE

\$12,000,000.00

February 4, 2009
Irvine, California

For value received, the undersigned, Iteris, Inc., a Delaware corporation, with an address of 1700 Carnegie Avenue, Suite 100, Santa Ana, California 92705 ("Borrower"), promises to pay to the order of California Bank & Trust, a California banking corporation, with an address of Orange County Corporate Banking Office, 19200 Von Karman Avenue, Suite 140, Irvine, California 92612 (together with its successors and assigns, "Bank"), the principal amount of Twelve Million and No/100 Dollars (\$12,000,000.00) or, if less, such amount as may be the aggregate unpaid principal amount of all loans or advances made by Bank to Borrower pursuant hereto, on or before October 1, 2010 (the "Maturity Date"), together with interest from the date hereof on the unpaid principal balance from time to time outstanding until paid in full.

This Note amends and restates that certain Promissory Note dated October 16, 2008, by Borrower in favor of Bank in the original principal amount of \$12,000,000.00 and continues to evidence, and does not extinguish or satisfy, the indebtedness and other obligations of Borrower thereunder. Nothing in this Note shall constitute or be deemed to constitute a novation.

The aggregate principal balance outstanding shall bear interest, and interest shall be payable, in accordance with that certain Interest Rate Election Rider attached hereto and made a part hereof (the "Interest Election Rider").

This Note is secured by all collateral granted to Bank by Borrower or any endorser or guarantor hereof or by any other party and shall be secured by any additional collateral hereafter granted to Bank by Borrower or any endorser or guarantor hereof or by any other party.

Principal and interest shall be payable at Bank's main office or at such other place as Bank may designate in writing in immediately available funds in lawful money of the United States of America without set-off, deduction or counterclaim. Interest shall be calculated on the basis of actual number of days elapsed and a 360-day year.

This Note is a revolving note and, subject to the foregoing and in accordance with the provisions hereof and of any and all other agreements between Borrower and Bank related hereto, Borrower may, at its option, borrow, pay, prepay and reborrow hereunder at any time prior to the Maturity Date or such earlier date as the obligations of Borrower to Bank under this Note, and any other agreements between Bank and Borrower related hereto, shall become due and payable, or the obligation of Bank to extend financial accommodations to Borrower shall terminate; *provided, however*, that in any event the principal balance outstanding hereunder shall at no time exceed the face amount of this Note. This Note shall continue in full force and effect until all obligations and liabilities evidenced by this Note are paid in full and Bank is no longer obligated to extend financial accommodations to Borrower, even if, from time to time, there are no amounts outstanding respecting this Note.

For as long as the credit facility evidenced by this Note remains in existence, Borrower shall pay to Bank a fee ("Unused Line Fee") in the form of additional interest on that portion of the maximum principal amount of this Note that on each day is not outstanding ("Unused Portion"), which interest shall accrue daily by multiplying the Unused Portion each day by a per diem rate equal to 0.25% divided by 360. The Unused Line Fee shall be due and payable quarterly in arrears.

At the option of Bank, this Note shall become immediately due and payable without notice or demand upon the occurrence at any time of any Event of Default, as defined in that certain Amended and Restated Loan and Security Agreement, dated as of even date herewith, between Borrower and Bank (the "Loan Agreement").

Any payments received by Bank on account of this Note shall, at Bank's option, be applied, first, to accrued and unpaid interest; second, to the unpaid principal balance hereof; and, third, to any costs, expenses or charges (including without limitation late charges) then owed to Bank by Borrower. Notwithstanding the foregoing, any payments received after the occurrence and during the continuance of an Event of Default shall be applied in such manner as Bank may determine. Borrower hereby authorizes Bank to charge any deposit account which Borrower may maintain with Bank for any payment required hereunder, and, so long as no Event of Default shall have occurred and be continuing, Bank agrees to give Borrower written notice of any such charge.

If pursuant to the terms of this Note, Borrower is at any time obligated to pay interest on the principal balance at a rate in excess of the maximum interest rate permitted by applicable law for the loan evidenced by this Note, the applicable interest rate shall be immediately reduced to such maximum rate and all previous payments in excess of the maximum rate shall be deemed to have been payments in reduction of principal and not on account of the interest due hereunder. More specifically, if from any circumstances whatsoever, fulfillment of any provision of this Note or any other loan document executed and delivered in connection with this Note, at the time performance of such provision becomes due, would exceed the limit on interest then permitted by any applicable usury statute or any other applicable law, Bank may, at its option, (a) reduce the obligations to be fulfilled to such limit on interest, or (b) apply the amount in excess of such limit on interest to the reduction of the outstanding principal balance of the obligations, and not to the payment of interest, with the same force and effect as though Borrower had specifically designated such sums to be so applied to principal and Bank had agreed to accept such extra payments as a premium-free prepayment, so that in no event shall any exaction be possible under this Note or any other loan document that is in excess of the applicable limit on interest. It is the intention of Borrower and Bank that the total liability for payments in the nature of interest shall not exceed the limits imposed by any applicable state or federal interest rate laws. The provisions of this paragraph shall control every other provision of this Note and any provision of any other loan document in conflict with this paragraph.

Borrower represents to Bank that the proceeds of this Note will not be used for personal, family or household purposes or for the purpose of purchasing or carrying margin stock or margin securities within the meaning of Regulations U and X of the Board of Governors of the Federal Reserve System, 12 C.F.R. Parts 221 and 224.

No delay or omission on the part of Bank in exercising any right hereunder shall operate as a waiver of such right or of any other right of Bank, nor shall any delay, omission or waiver on any one occasion be deemed a bar to or waiver of the same or any other right on any future occasion. Borrower and every endorser or guarantor of this Note, regardless of the time, order or place of signing, waives presentment, demand, protest, notice of dishonor, notice of protest, notice of intent to accelerate, notice of acceleration and all other notices of every kind in connection with the delivery, acceptance, performance or enforcement of this Note and assents to any extension or postponement of the time of payment or any other indulgence, to any substitution, exchange or release of collateral, and to the addition or release of any other party or person primarily or secondarily liable and waives all recourse to suretyship and guarantor defenses generally, including any defense based on impairment of collateral, and any right (whether now or hereafter existing) to require the holder hereof to first proceed against Borrower or any endorser or guarantor for any security.

Borrower and each endorser and guarantor of this Note agrees to pay, upon demand, costs of collection of all amounts under this Note, including without limitation principal and interest, or in connection with the enforcement of or realization on any security for this Note, including without limitation, to the extent permitted by applicable law, reasonable attorneys' fees and expenses. Upon the occurrence and during the continuance of an Event of Default, interest shall accrue at a rate per annum equal to five percent (5.0%) plus the then-current Wall Street Journal Prime Rate or LIBOR Rate, as the case may be, applicable to advances outstanding at such time. If any payment due under this Note is unpaid for 15 days or more, Borrower shall pay, in addition to any other sums due under this Note (and without limiting Bank's other remedies on account thereof), a late charge equal to the lesser of \$500 or 6.0% of such unpaid amount.

This Note shall be binding upon Borrower and each endorser and guarantor hereof and upon their respective heirs, successors, assigns and legal representatives and shall inure to the benefit of Bank and its successors, endorsees and assigns.

Borrower and each endorser and guarantor, if any, hereby waive presentment, demand, protest, notice of dishonor, notice of protest and all other notices and demands of every kind and all suretyship defenses of any kind, in each case that would otherwise be available in connection with this Note, including without limitation any right (whether now or hereafter existing) to require the holder hereof to first proceed against Borrower or any endorser or guarantor for any security.

In the event that at any time, a surety is liable upon only a portion of Borrower's or any endorser's or guarantor's obligations under this Note and Borrower provides partial satisfaction of any such obligations, Borrower and each endorser and guarantor hereof, if any, hereby waives any right it would otherwise have under Section 2822 of the California Civil Code to designate the portion of the obligations to be satisfied. The designation of the portion of the obligation to be satisfied shall, to the extent not expressly made by the terms of this Note, be made by Bank rather than Borrower.

The liabilities of Borrower and any endorser or guarantor of this Note are joint and several; *provided, however*, the release by Bank of Borrower or any one or more endorsers or guarantors shall not release any other person obligated on account of this Note. Any and all present and future debts of Borrower to any endorser or guarantor of this Note are subordinated to the full payment and performance of all present and future debts and obligations of Borrower to Bank. Each reference in this Note to Borrower, any endorser and any guarantor is to such person individually and also to all such persons jointly. No person obligated on account of this Note may seek contribution from any other person also obligated, unless and until all liabilities, obligations and indebtedness to Bank of the person from whom contribution is sought have been irrevocably satisfied in full. The release or compromise by Bank of any collateral shall not release any person obligated on account of this Note.

Borrower and each endorser and guarantor hereof authorizes Bank to complete this Note if delivered incomplete in any respect. A photographic or other reproduction of this Note may be made by Bank, and any such reproduction shall be admissible in evidence with the same effect as the original itself in any judicial or administrative proceeding, whether or not the original is in existence.

Borrower will from time to time execute and deliver to Bank such documents, and take or cause to be taken all such other further action, as Bank may request in order to effect and confirm or vest more securely in Bank all rights contemplated by this Note or any other loan documents related thereto (including without limitation to correct clerical errors) or to vest more fully in or assure to Bank the security interest in any collateral securing this Note or to comply with applicable statute or law.

This Note is delivered to Bank at one of its offices in California and shall be governed by the internal laws of the State of California without regard to principles of conflict of laws.

Any notices under or pursuant to this Note shall be deemed duly received and effective if delivered in hand to any officer or agent of Borrower or Bank, or if mailed by registered or certified mail, return receipt requested, addressed to Borrower or Bank at the address set forth in this Note or as any party may from time to time designate by written notice to the other party.

The term "Bank Affiliate" as used in this Note shall mean any Affiliate of Bank or any lender acting as a participant under any loan arrangement between Bank and Borrower. The term "Affiliate" shall mean, with respect to any person, (a) any person which, directly or indirectly through one or more intermediaries controls, is controlled by or is under common control with such person, or (b) any person who is a director or officer (i) of such person, (ii) of any subsidiary of such person, or (iii) any person described in clause (a) above. For purposes of this definition, "control" of a person shall mean the power, direct or indirect, (x) to vote 5% or more of the capital stock having ordinary voting power for the election of directors (or comparable equivalent) of such person, or (y) to direct or cause the direction of the management and policies of such person, whether by contract or otherwise. Control may be by ownership, contract or otherwise.

Borrower hereby grants to Bank a continuing lien and security interest in any and all deposit accounts (including without limitation time, savings, checking and money market accounts and certificates of deposit), whether now existing or hereafter opened and including without limitation any deposit accounts held jointly with a third party, or other sums at any time credited by or due from Bank or any Bank Affiliate to Borrower and any cash, securities, instruments or other property of Borrower in the possession of Bank or any Bank Affiliate, whether for safekeeping or otherwise, or in transit to or from Bank or any Bank Affiliate (regardless of the reason Bank or Bank Affiliate had received the same or whether Bank or Bank Affiliate has conditionally released the same), as security for the full and punctual payment and performance of all of the liabilities and obligations of Borrower to Bank or any Bank Affiliate, and such deposits and other sums may be applied against such liabilities and obligations of Borrower to Bank or any Bank Affiliate at any time, whether or not such are then due, whether or not demand has been made and whether or not other collateral is then available to Bank or any Bank Affiliate.

Borrower hereby certifies to Bank that all financial information ("financial information") submitted to Bank now and at all times during the term of this Note does and will fairly and accurately represent the financial condition of Borrower and each Bank Affiliate and each endorser and guarantor of this Note. Financial information includes, but is not limited to, all business financial statements (including interim and year-end financial statements that are company prepared and/or CPA prepared), business income tax returns, borrowing base certificates, accounts payable and receivable agings, personal financial statements and personal tax returns. Borrower understands that Bank will rely on all information, whenever provided, and that such information is a material inducement to Bank to make, to continue to make, or otherwise extend credit accommodations to Borrower. Borrower covenants and agrees to notify Bank in writing of any adverse material changes in its financial condition in the future. Borrower further understands and acknowledges that there are criminal penalties for giving false information to federally insured financial institutions.

Borrower and each endorser and guarantor of this Note each irrevocably submits to the nonexclusive jurisdiction of any federal or state court sitting in California, over any suit, action or proceeding arising out of or relating to this Note. Borrower and each endorser and guarantor irrevocably waives, to the fullest extent it may effectively do so under applicable law, any objection it may now or hereafter have to the laying of the venue of any such suit, action or proceeding brought in any such court and any claim that the same has been brought in an inconvenient forum. Borrower and each endorser and guarantor hereby consents to any and all process which may be served in any such suit, action or proceeding, (i) by mailing a copy thereof by registered or certified mail, postage prepaid, return receipt requested, to Borrower's, endorser's or guarantor's address shown below or as notified to Bank and (ii) by serving the same upon Borrower and any endorsers or guarantors in any other manner otherwise permitted by law, and agrees that such service shall in every respect be deemed effective service upon Borrower or such endorser or guarantor.

BORROWER, EACH ENDORSER AND GUARANTOR AND BANK HEREBY AGREE THAT SECTIONS 8.18 AND 8.19 OF THE LOAN AGREEMENT WITH RESPECT TO JURY WAIVER AND JUDICIAL REFERENCE SHALL GOVERN IN ANY ACTION OR PROCEEDING IN CONNECTION WITH THIS NOTE.

Executed as of February 4, 2009

Borrower:

Iteris, Inc.,
a Delaware corporation

By: /s/ James S. Miele
James S. Miele, Chief Financial Officer
For Iteris, Inc.

By: /s/ Abbas Mohaddes
Abbas Mohaddes, Chief Executive Officer

Address: 1700 Carnegie Avenue, Suite 100
Santa Ana, California 92705

INTEREST RATE ELECTION RIDER

1. INTEREST RATES; PAYMENTS AND PREPAYMENTS

1.1 Interest Rates. So long as no Event of Default shall have occurred and be continuing and subject to the other terms of this Note, the outstanding principal balance shall bear interest at a rate per annum for the Interest Periods which Borrower selects in accordance with this section and the other provisions of this Note equal to (a) a variable rate (the "Variable Rate") equal to the Wall Street Journal Prime Rate plus the Applicable Margin (a "Variable Rate Advance"); or (b) the LIBOR Rate for Interest Periods of one, two or three months, but not longer than the remainder of the term of this Note, plus the Applicable Margin (a "LIBOR Advance").

1.2 Rate Selection. When Borrower desires to select an interest rate, Borrower shall give Bank three (3) days' prior written notice specifying the effective date thereof (which shall be a Banking Day), the type of interest rate, the amount to which the interest rate shall apply and the duration of the first Interest Period therefor. Any such notice shall be irrevocable and shall be subject to other terms and conditions set forth in this Note. If Bank does not receive timely notice of a requested LIBOR Advance, Borrower shall be deemed to have selected a Variable Rate Advance. Each LIBOR Advance may only be requested in increments of \$500,000.00 and no more than two (2) LIBOR Advances may be outstanding at any one time. If any interest rate is selected, Bank shall record on the books and records of Bank an appropriate notation evidencing such selection, each repayment on account of the principal thereof and the amount of interest paid, and Borrower authorizes Bank to maintain such records and make such notations and agrees that the amount shown on the books and records as outstanding from time to time shall constitute the amount owing to Bank pursuant to this Note, absent manifest error.

1.3 Payment of Interest. Interest on all amounts outstanding (except for LIBOR Advances) shall be payable monthly in arrears on the first day of each month commencing the month following the date of this Note, and continuing thereafter on the same day of each succeeding month until the principal balance shall be paid in full. Interest on all LIBOR Advances shall be payable, in arrears, on the first Banking Day following the expiration of the applicable Interest Period and, in respect of any LIBOR Advance of more than three (3) months' duration, interest shall also be payable, in arrears, on each earlier Banking Day which is three (3) months after the first day of the applicable Interest Period.

1.4 Interest Periods. Each Interest Period shall commence and shall end as set forth in Section 2.1(c) hereof; *provided, however*, that (a) any Interest Period that would otherwise end on a day which is not a Banking Day shall be extended to the next Banking Day unless such extension would carry such Interest Period into the next month, in which event such Interest Period shall end on the preceding Banking Day; (b) any Interest Period that begins on the last Banking Day of a calendar month (or on a date for which there is no numerically corresponding day in the calendar month during which such Interest Period is to end), shall (subject to clause (a) above) end on the last Banking Day of such calendar month; and (c) any Interest Period that would otherwise extend beyond the Maturity Date shall end on the Maturity Date.

1.5 Conversion of Outstanding Amounts. So long as no Event of Default shall have occurred and be continuing, Borrower may (a) on any Banking Day, convert any outstanding Variable Rate Advance to a LIBOR Advance in the same aggregate principal amount and (b) on the last Banking Day of the then current interest period applicable to a LIBOR Advance, convert such LIBOR Advance to a Variable Rate Advance. If Borrower desires to convert an advance as set forth in the prior sentence, it shall give Bank three (3) Banking Days' prior written notice, specifying the date of such conversion, the amount to be converted and if the conversion is from a Variable Rate Advance to a LIBOR Advance, the duration of the Interest Period therefor.

1.6 End of Interest Period. Subject to all of the terms and conditions applicable to a request that a new interest rate selected be a LIBOR Advance, Borrower may elect to continue a LIBOR Advance as of the last day of the applicable Interest Period to a new LIBOR Advance. If Borrower fails to notify Bank of the Interest Period for a subsequent LIBOR Advance at least Three (3) Banking Days prior to the last day of the then current Interest Period, then, at Bank's discretion, such outstanding LIBOR Advance shall become a Variable Rate Advance at the end of the current Interest Period for such outstanding LIBOR Advance and shall accrue interest in accordance with the provisions regarding Variable Rate Advances described herein.

1.7 Basis for Determining LIBOR Inadequate or Unfair. In the event that Bank shall determine that by reason of circumstances affecting the interbank Eurodollar market, adequate and reasonable means do not exist for determining the LIBOR Rate, or Eurodollar deposits in the relevant amount and for the relevant maturity are not available to Bank in the interbank Eurodollar market, with respect to a proposed LIBOR Advance or a proposed conversion of any Variable Rate Advance to a LIBOR Advance, Bank shall give Borrower prompt notice of such determination. If such notice is given, then: (a) any requested LIBOR Advance shall be made as a Variable Rate Advance, unless Borrower gives Bank one Banking Day's prior written notice that its request for such borrowing is canceled; (b) any advance which was to have been converted to a LIBOR Advance shall be continued as a Variable Rate Advance; and (c) any outstanding LIBOR Advance shall be converted to a Variable Rate Advance on the last Banking Day of the then current Interest Period for such LIBOR Advance. Until such notice has been withdrawn, Bank shall have no obligation to make LIBOR Advances or maintain outstanding LIBOR Advances and Borrower shall not have the right to request LIBOR Advances or convert advances to LIBOR Advances.

1.8 Illegality of LIBOR Rate. Notwithstanding any other provision of this Note, if, after the date of this Note, any applicable law, treaty, regulation or directive, or any change therein or in the interpretation or application thereof, shall make it unlawful for Bank to make or maintain any LIBOR Advance, the obligation of Bank hereunder to make or maintain such LIBOR Advance shall forthwith be suspended for the duration of such illegality and Borrower shall, if any such LIBOR Advance is outstanding, promptly upon request from Bank, prepay such LIBOR Advance or convert such LIBOR Advance to another type of advance. If any such payment is made on a day that is not the last Banking Day of the then current Interest Period applicable to such advance, Borrower shall pay Bank, upon Bank's request, any amount required under Section 1.10 of this Note.

1.9 Termination of Pricing Option. After the occurrence of an Event of Default, Borrower's right to select pricing options, if applicable, shall cease, and, if Borrower would, but for the application of the preceding clause, have had the right to elect among interest rate options, notwithstanding anything to the contrary in this Note, interest shall accrue at a rate per annum equal to five percent (5.0%) plus the then-current Wall Street Journal Prime Rate or LIBOR Rate, as the case may be, applicable to advances outstanding at such time.

1.10 Optional Prepayment.

(a) Borrower has the right to pay before due the unpaid balance of any Variable Rate Advance or any part thereof without penalty or premium, but with accrued interest on the principal being prepaid to the date of such repayment.

(b) At its option and upon prior written notice to Bank, Borrower may prepay any LIBOR Advance in whole or in part from time to time without premium or penalty but with accrued interest on the principal being prepaid to the date of such repayment; *provided, however*, that such LIBOR Advance may only be prepaid on the last Banking Day of the then current Interest Period applicable thereto.

(c) In the event that any prepayment of a LIBOR Advance is required or permitted on a date other than the last Banking Day of the then current Interest Period applicable thereto, then so long as this Note has not become due and payable in accordance with its terms, Borrower shall have the right to prepay such LIBOR Advance in whole (but not in part), *provided*, that Borrower shall pay to Bank concurrently with such prepayment a Yield Maintenance Fee in an amount computed as follows: The current rate for United States Treasury securities (bills on a discounted basis shall be converted to a bond equivalent) with a maturity date closest to the maturity date of the term chosen pursuant to the Interest Period as to which the prepayment is made, shall be subtracted from the "cost of funds" component of the LIBOR Advance in effect at the time of prepayment. If the result is zero or a negative number, there shall be no Yield Maintenance Fee payable. If the result is a positive number, then the resulting percentage shall be multiplied by the amount of the principal balance being prepaid. The resulting amount shall be divided by 360 and multiplied by the number of days remaining in the term chosen pursuant to the Interest Period as to which the prepayment is made. Said amount shall be reduced to present value

calculated by using the number of days remaining in the designated term and using the above-referenced United States Treasury security rate and the number of days remaining in the designated term chosen pursuant to the Interest Period as to which the prepayment is made. The resulting amount shall be the Yield Maintenance Fee due to Bank upon prepayment of the LIBOR Advance. If this Note shall become due and payable for any reason, then any Yield Maintenance Fee with respect to the Note shall become due and payable in the same manner as though Borrower had exercised its right of prepayment. Borrower recognizes that Bank will incur substantial additional costs and expenses including loss of yield and anticipated profitability in the event of prepayment of all or part of this Note and that the Yield Maintenance Fee compensates Bank for such costs and expenses. Borrower acknowledges that the Yield Maintenance Fee is bargained-for consideration and not a penalty.

(d) All prepayments of any LIBOR Advance shall be applied first to fees and expenses then due hereunder, then to interest on the unpaid principal balance accrued to the date of prepayment and last to the principal balance then due hereunder.

2. DEFINITIONS

2.1 Definitions. The following definitions are applicable to this Interest Rate Election Rider:

(a) “Applicable Margin” shall mean the rate determined based on the percentage of the average aggregate balance of all demand deposit accounts (including without limitation time, savings, checking and money market accounts) maintained by Borrower with Bank as compared to the average total loan or credit commitments by Bank to Borrower (the “DDA Percentage”), measured on a quarterly basis as of the end of each fiscal quarter, as follows:

DDA Percentage	Applicable Margin for Variable Rate Advances	Applicable Margin for LIBOR Advances
25% or greater	0.00%	2.50%
15% to (but not including) 25%	0.25%	2.75%
Less than 15%	0.50%	3.00%

Any change in the Applicable Margin resulting from the measurement of the DDA Percentage as of the end of a fiscal quarter shall be effective on the first day of the immediately following fiscal quarter.

(b) “Banking Day” shall mean with respect to LIBOR Advances, a London Banking Day and with respect to all other advances, any day other than a day on which commercial banks in California are required or permitted by law to close.

(c) “Interest Period” shall mean, with respect to any LIBOR Advance, the one, two or three month period selected by Borrower pursuant to Section 1.1. The actual length of such periods shall be calculated as set forth below. The initial Interest Period, unless commenced on the first Banking Day of a month, shall, notwithstanding the length of the Interest Period selected by Borrower, (i) for Interest Periods beginning before the 25th of each calendar month, end on the first Banking Day of the month following commencement of the initial Interest Period; and (ii) for Interest Periods beginning on or after the 25th of each calendar month, end on the first Banking Day of the second month following commencement of the initial Interest Period. All subsequent Interest Periods for any particular LIBOR Advance shall commence on the first Banking Day of the relevant month and end of the first Banking Day of the month determined by the length of the Interest Period selected by Borrower pursuant to this provision. Bank’s calculation of the length of Interest Periods shall be in its sole and absolute discretion and shall conclusively bind Borrower absent manifest error.

(d) “LIBOR Advance” shall have the meaning set forth in Section 1.1 above.

(e) “LIBOR Rate” shall mean the rate per annum for the relevant Interest Period determined as of the start of each Interest Period as quoted by Bank as Bank’s LIBOR Rate based on quotes from the London Interbank Offered Rate from the British Bankers Association Interest Settlement Rates, as quoted for U.S. Dollars by Bloomberg, or other comparable service selected by Bank. The Interest Period shall be Note N LIBOR Rate Period. This definition of LIBOR Rate is to be strictly interpreted and is not intended to serve any purpose other than providing an index to determine the interest rate used herein. The LIBOR Rate may not necessarily be the same as the quoted offered side in the Eurodollar time deposit market by any particular institution or service applicable to any Interest Period. The effective interest rate applicable to Borrower’s loans evidenced hereby shall change as of the beginning of each Interest Period if there is a change in the LIBOR Rate as of any such date.

(f) “London Banking Day” shall mean with respect to LIBOR Advances, any day on which commercial banks are open for international business (including dealings in U.S. Dollar (\$) deposits) in London, England and California.

(g) “Variable Rate Advance” shall have the meaning set forth in Section 1.1 above.

(h) “Wall Street Journal Prime Rate” shall mean the highest rate published from time to time by the *Wall Street Journal* as the Prime Rate, or, in the event the *Wall Street Journal* ceases publication of the Prime Rate, the base, reference or other rate then designated by Bank, in its sole discretion, for general commercial loan reference purposes, it being understood that such rate is a reference rate, not necessarily the lowest, established from time to time, which serves as the basis upon which effective interest rates are calculated for loans making reference thereto.

2.2 Other Terms. Capitalized terms used but not otherwise defined in this Note (including without limitation this Interest Rate Election Rider) shall have the respective meanings ascribed to them in the Loan Agreement.

AMENDED AND RESTATED NON-REVOLVING-TO-TERM NOTE

\$7,500,000.00

February 4, 2009
Irvine, California

For value received, the undersigned, Iteris, Inc., a Delaware corporation, with an address of 1700 Carnegie Avenue, Suite 100, Santa Ana, California 92705 ("Borrower"), promises to pay to the order of California Bank & Trust, a California banking corporation, with an address of Orange County Corporate Banking Office, 19200 Von Karman Avenue, Suite 140, Irvine, California 92612 (together with its successors and assigns, "Bank"), the principal amount of Seven Million, Five Hundred Thousand and No/100 Dollars (\$7,500,000.00) or, if less, such amount as may be the aggregate unpaid principal amount of all loans or advances made by Bank to Borrower pursuant hereto, on or before May 1, 2013 (the "Maturity Date") as set forth below, together with interest from the date hereof on the unpaid principal balance from time to time outstanding until paid in full.

This Note amends and restates that certain Promissory Note dated October 16, 2008, by Borrower in favor of Bank in the original principal amount of \$7,500,000.00 and continues to evidence, and does not extinguish or satisfy, the indebtedness and other obligations of Borrower thereunder. Nothing in this Note shall constitute or be deemed to constitute a novation.

The aggregate principal balance outstanding shall bear interest thereon at a rate per annum equal to the Wall Street Journal Prime Rate plus the Applicable Margin. The current Wall Street Journal Prime Rate is Four Percent (4.0%) and the initial Applicable Margin is One Percent (1.0%). Accordingly, the initial applicable interest rate is equal to Five Percent (5.0%) until changed in accordance with the terms of this Note.

"Wall Street Journal Prime Rate" means the highest rate published from time to time by the *Wall Street Journal* as the Prime Rate or, in the event the *Wall Street Journal* ceases publication of the Prime Rate, the base, reference or other rate then designated by Bank, in its sole discretion, for general commercial loan reference purposes, it being understood that such rate is a reference rate, not necessarily the lowest, established from time to time, which serves as the basis upon which effective interest rates are calculated for loans making reference thereto. The effective interest rate applicable to Borrower's loans evidenced hereby shall change on the date of each change in the Wall Street Journal Prime Rate.

The "Applicable Margin" shall be determined by the percentage of the average aggregate balance of all demand deposit accounts (including without limitation time, savings, checking and money market accounts) maintained by Borrower with Bank as compared to the average total loan or credit commitments by Bank to Borrower (the "DDA Percentage"), measured on a quarterly basis as of the end of each fiscal quarter, as follows:

DDA Percentage	Applicable Margin
25% or greater	0.50%
15% to (but not including) 25%	0.75%
Less than 15%	1.00%

Any change in the Applicable Margin resulting from the measurement of the DDA Percentage as of the end of a fiscal quarter shall be effective on the first day of the immediately following fiscal quarter.

This Note evidences a non-revolving-to-term loan for the purpose of retiring debentures issued by Borrower. Advances may be made hereunder from time to time until May 1, 2009 (the "Conversion Date"). Interest on the outstanding principal balance shall be due and payable in arrears monthly commencing the month following the date of the first advance on the first day of each month. The outstanding principal balance on the Conversion Date shall be repaid in equal installments of principal based upon a 48-month amortization period commencing on the Conversion Date, except that the last installment shall be due and payable on the Maturity Date and shall be in an amount equal to the aggregate outstanding balance on the Maturity Date.

Beginning on November 1, 2009, and on November 1 of each year thereafter, Borrower agrees to pay to Bank an amount equal to fifty percent (50%) of Borrower's EBITDA for the immediately preceding fiscal year, net of taxes, capital expenditures up to \$1,500,000.00, interest paid and current portion of long-term debt for such fiscal year (the "Excess Cash Flow Recapture Amount"), which payment shall be applied to the outstanding principal balance under this Note; *provided, however*, in no event shall Borrower's obligation to pay the Excess Cash Flow Recapture Amount exceed \$500,000.00 in any year. As used herein, "EBITDA" shall mean, for any period, earnings from continuing operations before payment of federal, state and local income taxes, plus interest expense, depreciation and amortization, in each case for such period, calculated in accordance with Generally Accepted Accounting Principles in effect from time to time in the United States.

This Note is secured by all collateral granted to Bank by Borrower or any endorser or guarantor hereof or by any other party and shall be secured by any additional collateral hereafter granted to Bank by Borrower or any endorser or guarantor hereof or by any other party.

Principal and interest shall be payable at Bank's main office or at such other place as Bank may designate in writing in immediately available funds in lawful money of the United States of America without set-off, deduction or counterclaim. Interest shall be calculated on the basis of actual number of days elapsed and a 360-day year.

At the option of Bank, this Note shall become immediately due and payable without notice or demand upon the occurrence at any time of any Event of Default, as defined in that certain Amended and Restated Loan and Security Agreement, dated as of even date herewith, between Borrower and Bank (the "Loan Agreement").

Any payments received by Bank on account of this Note shall, at Bank's option, be applied, first, to accrued and unpaid interest; second, to the unpaid principal balance hereof; and, third, to any costs, expenses or charges (including without limitation late charges) then owed to Bank by Borrower. Notwithstanding the foregoing, any payments received after the occurrence and during the continuance of an Event of Default shall be applied in such manner as Bank may determine. Borrower hereby authorizes Bank to charge any deposit account which Borrower may maintain with Bank for any payment required hereunder, and, so long as no Event of Default shall have occurred and be continuing, Bank agrees to give Borrower written notice of any such charge.

If pursuant to the terms of this Note, Borrower is at any time obligated to pay interest on the principal balance at a rate in excess of the maximum interest rate permitted by applicable law for the loan evidenced by this Note, the applicable interest rate shall be immediately reduced to such maximum rate and all previous payments in excess of the maximum rate shall be deemed to have been payments in reduction of principal and not on account of the interest due hereunder. More specifically, if from any circumstances whatsoever, fulfillment of any provision of this Note or any other loan document excuted and delivered in connection with this Note, at the time performance of such provision becomes due, would exceed the limit on interest then permitted by any applicable usury statute or any other applicable law, Bank may, at its option, (a) reduce the obligations to be fulfilled to such limit on interest, or (b) apply the amount in excess of such limit on interest to the reduction of the outstanding principal balance of the obligations, and not to the payment of interest, with the same force and effect as though Borrower had specifically designated such sums to be so applied to principal and Bank had agreed to accept such extra payments as a premium-free prepayment, so that in no event shall any exaction be possible under this Note or any other loan document that is in excess of the applicable limit on interest. It is the intention of Borrower and Bank that the total liability for payments in the nature of interest shall not exceed the limits imposed by any applicable state or federal interest rate laws. The provisions of this paragraph shall control every other provision of this Note and any provision of any other loan document in conflict with this paragraph.

Borrower represents to Bank that the proceeds of this Note will not be used for personal, family or household purposes or for the purpose of purchasing or carrying margin stock or margin securities within the meaning of Regulations U and X of the Board of Governors of the Federal Reserve System, 12 C.F.R. Parts 221 and 224.

No delay or omission on the part of Bank in exercising any right hereunder shall operate as a waiver of such right or of any other right of Bank, nor shall any delay, omission or waiver on any one occasion be deemed a bar to or waiver of the same or any other right on any future occasion. Borrower and every endorser or guarantor of this Note, regardless of the time, order or place of signing, waives presentment, demand, protest, notice of dishonor, notice of protest, notice of intent to accelerate, notice of acceleration and all other notices of every kind in connection with the delivery, acceptance, performance or enforcement of this Note and assents to any extension or postponement of the time of payment or any other indulgence, to any substitution, exchange or release of collateral, and to the addition or release of any other party or person primarily or secondarily liable and waives all recourse to suretyship and guarantor defenses generally, including any defense based on impairment of collateral, and any right (whether now or hereafter existing) to require the holder hereof to first proceed against Borrower or any endorser or guarantor for any security.

Borrower and each endorser and guarantor of this Note agrees to pay, upon demand, costs of collection of all amounts under this Note, including without limitation principal and interest, or in connection with the enforcement of or realization on any security for this Note, including without limitation, to the extent permitted by applicable law, reasonable attorneys' fees and expenses. Upon the occurrence and during the continuance of an Event of Default, interest shall accrue at a rate per annum equal to five percent (5.0%) plus the then-current Wall Street Journal Prime Rate or LIBOR Rate, as the case may be, applicable to advances outstanding at such time. If any payment due under this Note is unpaid for 15 days or more, Borrower shall pay, in addition to any other sums due under this Note (and without limiting Bank's other remedies on account thereof), a late charge equal to the lesser of \$500 or 6.0% of such unpaid amount.

This Note shall be binding upon Borrower and each endorser and guarantor hereof and upon their respective heirs, successors, assigns and legal representatives and shall inure to the benefit of Bank and its successors, endorsees and assigns.

Borrower and each endorser and guarantor, if any, hereby waives presentment, demand, protest, notice of dishonor, notice of protest and all other notices and demands of every kind, and all suretyship defenses of any kind, in each case that would otherwise be available in connection with this Note including without limitation any right (whether now or hereafter existing) to require the holder hereof to first proceed against Borrower, or any endorser or guarantor, for any security.

In the event that at any time, a surety is liable upon only a portion of Borrower's or any endorser's or guarantor's obligations under this Note and Borrower provides partial satisfaction of any such obligations, each of Borrower and each endorser and guarantor hereof, if any, hereby waives any right it would otherwise have under Section 2822 of the California Civil Code to designate the portion of the obligations to be satisfied. The designation of the portion of the obligation to be satisfied shall, to the extent not expressly made by the terms of this Note, be made by Bank rather than Borrower.

The liabilities of Borrower and any endorser or guarantor of this Note are joint and several; *provided, however*, the release by Bank of Borrower or any one or more endorsers or guarantors shall not release any other person obligated on account of this Note. Any and all present and future debts of Borrower to any endorser or guarantor of this Note are subordinated to the full payment and performance of all present and future debts and obligations of Borrower to Bank. Each reference in this Note to Borrower, any endorser and any guarantor is to such person individually and also to all such persons jointly. No person obligated on account of this Note may seek contribution from any other person also obligated, unless and until all liabilities, obligations and indebtedness to Bank of the person from whom contribution is sought have been irrevocably satisfied in full. The release or compromise by Bank of any collateral shall not release any person obligated on account of this Note.

Borrower and each endorser and guarantor hereof authorizes Bank to complete this Note if delivered incomplete in any respect. A photographic or other reproduction of this Note may be made by Bank, and any such reproduction shall be admissible in evidence with the same effect as the original itself in any judicial or administrative proceeding, whether or not the original is in existence.

Borrower will from time to time execute and deliver to Bank such documents, and take or cause to be taken all such other further action, as Bank may request in order to effect and confirm or vest more securely in Bank all rights contemplated by this Note or any other loan documents related thereto (including without limitation to correct clerical errors) or to vest more fully in or assure to Bank the security interest in any collateral securing this Note or to comply with applicable statute or law.

This Note is delivered to Bank at one of its offices in California and shall be governed by the internal laws of the State of California without regard to principles of conflict of laws.

Any notices under or pursuant to this Note shall be deemed duly received and effective if delivered in hand to any officer or agent of Borrower or Bank, or if mailed by registered or certified mail, return receipt requested, addressed to Borrower or Bank at the address set forth in this Note or as any party may from time to time designate by written notice to the other party.

The term "Bank Affiliate" as used in this Note shall mean any Affiliate of Bank or any lender acting as a participant under any loan arrangement between Bank and Borrower. The term "Affiliate" shall mean, with respect to any person, (a) any person which, directly or indirectly through one or more intermediaries controls, is controlled by or is under common control with such person, or (b) any person who is a director or officer (i) of such person, (ii) of any subsidiary of such person, or (iii) any person described in clause (a) above. For purposes of this definition, "control" of a person shall mean the power, direct or indirect, (x) to vote 5% or more of the capital stock having ordinary voting power for the election of directors (or comparable equivalent) of such person, or (y) to direct or cause the direction of the management and policies of such person, whether by contract or otherwise. Control may be by ownership, contract or otherwise.

Borrower hereby grants to Bank a continuing lien and security interest in any and all deposit accounts (including without limitation time, savings, checking and money market accounts or certificates of deposit), whether now existing or hereafter opened and including without limitation any deposit accounts held jointly with a third party, or other sums at any time credited by or due from Bank or any Bank Affiliate to Borrower and any cash, securities, instruments or other property of Borrower in the possession of Bank or any Bank Affiliate, whether for safekeeping or otherwise, or in transit to or from Bank or any Bank Affiliate (regardless of the reason Bank or Bank Affiliate had received the same or whether Bank or Bank Affiliate has conditionally released the same), as security for the full and punctual payment and performance of all of the liabilities and obligations of Borrower to Bank or any Bank Affiliate, and such deposits and other sums may be applied against such liabilities and obligations of Borrower to Bank or any Bank Affiliate at any time, whether or not such are then due, whether or not demand has been made and whether or not other collateral is then available to Bank or any Bank Affiliate.

Borrower hereby certifies to Bank that all financial information ("financial information") submitted to Bank now and at all times during the term of this Note does and will fairly and accurately represent the financial condition of Borrower and each Bank Affiliate and each endorser and guarantor of this Note. Financial information includes, but is not limited to, all business financial statements (including interim and year-end financial statements that are company prepared and/or CPA prepared), business income tax returns, borrowing base certificates, accounts payable and receivable agings, personal financial statements and personal tax returns. Borrower understands that Bank will rely on all information, whenever provided, and that such information is a material inducement to Bank to make, to continue to make, or otherwise extend credit accommodations to Borrower. Borrower covenants and agrees to notify Bank in writing of any adverse material changes in its financial condition in the future. Borrower further understands and acknowledges that there are criminal penalties for giving false information to federally insured financial institutions.

Borrower and each endorser and guarantor of this Note each irrevocably submits to the nonexclusive jurisdiction of any federal or state court sitting in California over any suit, action or proceeding arising out of or relating to this Note. Borrower and each endorser and guarantor irrevocably waives, to the fullest extent it may effectively do so under applicable law, any objection it may now or hereafter have to the laying of the venue of any such suit, action or proceeding brought in any such court and any claim that the same has been brought in an inconvenient forum. Borrower and each endorser and guarantor hereby consents to any and all process which may be served in any such suit, action or proceeding, (i) by mailing a copy thereof by registered or certified mail, postage prepaid, return receipt requested, to Borrower's, endorser's or guarantor's address shown below or as notified to Bank and (ii) by serving the same upon Borrower and any endorsers or guarantors in any other manner otherwise permitted by law, and agrees that such service shall in every respect be deemed effective service upon Borrower or such endorser or guarantor.

BORROWER, EACH ENDORSER AND GUARANTOR AND BANK HEREBY AGREE THAT SECTIONS 8.18 AND 8.19 OF THE LOAN AGREEMENT WITH RESPECT TO JURY WAIVER AND JUDICIAL REFERENCE SHALL GOVERN IN ANY ACTION OR PROCEEDING IN CONNECTION WITH THIS NOTE.

Executed as of February 4, 2009

Borrower:

Iteris, Inc.,
a Delaware corporation

By: /s/ James S. Miele
James S. Miele, Chief Financial Officer
For Iteris, Inc.

By: /s/ Abbas Mohaddes
Abbas Mohaddes, Chief Executive Officer

Address: 1700 Carnegie Avenue, Suite 100
Santa Ana, California 92705

DEBENTURE REDEMPTION AGREEMENT

This Debenture Redemption Agreement ("***Agreement***") is entered into as of October 17, 2008 by and between ("***Holder***") and Iteris, Inc. ("***Iteris***" or the "***Company***").

RECITALS

WHEREAS, Holder holds a 6% Convertible Debenture dated May 19, 2004 in the principal amount of \$80,000.00 (the "***Debenture***"); and

WHEREAS, the parties hereto have reached certain agreements with respect to the redemption of the above-described debenture.

NOW, THEREFORE, in consideration of the foregoing and the mutual promises and agreements contained herein, the sufficiency of which is hereby acknowledged, the parties hereto agree as follows:

1. **Debenture Redemption.**

1.1. The Company agrees to redeem from Holder, and Holder agrees to sell back to the Company, the Debenture for an aggregate payment of Seventy-Six Thousand Dollars (\$76,000.00) (the "***Redemption Price***"). In addition to the payment of the Redemption Price, the Company shall pay at the Closing (as defined below) all accrued but unpaid interest on the Debenture as of the date of Closing.

1.2. The redemption of the Debenture (the "***Redemption***") shall take place at the offices of Dorsey & Whitney LLP, 38 Technology Drive, Suite 100, Irvine, California 92618, at 1:00 P.M. Pacific Time on October 17, 2008, or at such other time and place as the Company and Holder mutually agree orally or in writing (which time and place are designated as the "***Closing***"). At the Closing, Holder shall deliver to the Company the original of the Debenture against payment by the Company of the amounts set forth in Section 1.1 by check, wire transfer or any combination thereof. Notwithstanding the foregoing, Holder acknowledges and agrees that, upon and as of the payment by the Company of the amounts set forth in Section 1.1, whether or not Holder has delivered and surrendered the original of the Debenture to the Company, the Debenture shall be deemed null and void and cancelled in its entirety and Holder shall have no further rights with respect to or under the Debenture, whether such rights shall have accrued prior to or after the date hereof.

2. **Representations and Warranties.** Holder hereby represents, warrants and acknowledges as follows:

2.1. As of the date hereof, the principal amount outstanding under the Debenture is Eighty Thousand Dollars (\$80,000.00) and the accrued but unpaid interest outstanding under the Debenture is Two Hundred Ten Dollars and Forty-One Cents (\$210.41).

2.2. Holder is the sole record and beneficial owner of the Debenture. Upon payment of the amounts set forth in Section 1.1, the Company will acquire good and valid title to the Debenture, free and clear of all liens, security interests, pledges, claims and encumbrances of every kind, nature and description incurred or created by Holder.

2.3. Holder has the full right and power to enter into this Agreement, to perform its obligations hereunder and to consummate the transactions contemplated hereby. The execution, delivery and performance of this Agreement by Holder, and the consummation of the transactions contemplated hereby, (i) have been duly authorized by all requisite organizational action of Holder and (ii) do not and will not conflict with any law applicable to Holder or any of its properties or assets or any provisions of Holder's organizational documents or contracts, agreements or other instrument to which Holder is a party or by which any of its properties or assets may be bound.

2.4. Holder is an experienced and sophisticated investor, having such knowledge and experience in business and financial matters and investing as to be able to protect its own interests and assess the risks and merits of the Redemption. Holder has independently determined the advisability of entering into this Agreement and is entering into this Agreement of its own volition, and is not relying on any representations or statements of the Company or its officers, directors, shareholders, employees, agents, attorneys and representatives except for those representations and statements expressly set forth herein.

2.5. Holder has had the opportunity to consult with counsel of its choice regarding the meaning and legal effect of this Agreement, and regarding the advisability of making the agreements provided for herein, and fully understands the same.

3. Release. The following release shall be effective upon the Company's payment of the amounts set forth in Section 1.1.

3.1. Other than the obligations, covenants, representations and warranties provided for in this Agreement, Holder, for itself and its predecessors, successors, agents and assigns (individually and collectively, the "**Releasing Parties**"), hereby waives, releases, and forever discharges Iteris and its predecessors, successors, assigns, officers, directors, shareholders, employees, agents, attorneys and representatives, past and present, (collectively, the "**Iteris Released Parties**") of and from any and all rights, claims, debts, liabilities, demands, obligations, promises, damages, causes of action and claims for relief of any kind, manner, nature and description, known or unknown, which any of the Releasing Parties have, may have had, might have asserted, may now have or assert, or may hereafter have or assert against the Iteris Released Parties, or any of them, related to or arising under the Redemption and Holder's purchase and ownership of the Debenture. Holder represents and warrants that it has not filed any claims, charges, complaints or actions against the Company and has not assigned or transferred to any person or entity any of the claims Holder is releasing in this Agreement.

3.2. The Releasing Parties acknowledge and agree that the foregoing release includes in its effect all claims that they do not know or suspect to exist in their favor as of the date hereof, and the Releasing Parties expressly waive any statute, legal doctrine or other similar limitation upon the effect of general releases. In particular, the Releasing Parties waive any and

all rights and benefits conferred upon them by Section 1542 of the California Civil Code, which states as follows:

A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.

4. Governing Law. This Agreement shall in all respects be interpreted, enforced, and governed by and under the internal laws of the State of Delaware, without giving effect to any choice of law or conflict of law principles.

5. Entire Agreement. This Agreement constitutes the entire agreement between the parties with respect to the subject matter and supersedes all prior oral or written communications, understandings and agreements with respect thereto.

6. Headings. The use of headings in this Agreement is merely for convenience and such headings shall not be used in construing any provisions of this Agreement.

7. Interpretation. Each party has had the opportunity to negotiate modifications to the language of this Agreement and agrees that, in any dispute regarding the interpretation or construction of this Agreement, no presumption shall operate in favor of or against any party by virtue of its role in drafting or not drafting the terms and conditions set forth herein.

8. Severability. If any part, term or provision of this Agreement is held by a court to be void or voidable, illegal, unenforceable, invalid or otherwise in conflict with law, (i) the remaining provisions or applications of this Agreement shall not be affected and the rights and obligations of the parties shall be construed and enforced as if this Agreement did not contain the particular term or provision held to be invalid and (ii) such provision shall be amended to conform as nearly as possible, and only to the extent required, to applicable law.

9. Counterparts. This Agreement may be executed in several counterparts, each of which shall be deemed to be an original, and all such counterparts together shall constitute but one and the same instrument. A photocopy or facsimile signature may be used as an original.

[Signature Page Follows]

IN WITNESS WHEREOF, the undersigned have executed this Agreement to be effective as of the date first indicated above.

Iteris, Inc.	[]
By: _____	By: _____	
Name: _____	Name: _____	
Title: _____	Title: _____	

Schedule for Exhibit 10.2

Iteris, Inc. entered into a Debenture Redemption Agreement, each substantially identical to this Exhibit 10.2, with 4 affiliates of Bryant R. Riley.

DEBENTURE REDEMPTION AGREEMENT

This Debenture Redemption Agreement ("**Agreement**") is entered into as of October 27, 2008 by and between _____ ("**Holder**") and Iteris, Inc. ("**Iteris**" or the "**Company**").

RECITALS

WHEREAS, Holder holds a 6% Convertible Debenture dated May 19, 2004 in the principal amount of \$ _____ [and a 6% Convertible Debenture dated May 5, 2005 in the principal amount of \$ _____] (together, the "**Debentures**"); and

WHEREAS, the parties hereto have reached certain agreements with respect to the redemption of the above-described debentures.

NOW, THEREFORE, in consideration of the foregoing and the mutual promises and agreements contained herein, the sufficiency of which is hereby acknowledged, the parties hereto agree as follows:

1. **Debentures Redemption.**

1.1. The Company agrees to redeem from Holder, and Holder agrees to sell back to the Company, the Debentures for an aggregate payment of (\$ _____) (the "**Redemption Price**"). In addition to the payment of the Redemption Price, the Company shall pay at the Closing (as defined below) all accrued but unpaid interest on the Debentures as of the date of Closing.

1.2. The redemption of the Debentures (the "**Redemption**") shall take place at the offices of Dorsey & Whitney LLP, 38 Technology Drive, Suite 100, Irvine, California 92618, at 1:00 P.M. Pacific Time on October 27, 2008, or at such other time and place as the Company and Holder mutually agree orally or in writing (which time and place are designated as the "**Closing**"). At the Closing, Holder shall deliver to the Company the originals of the Debentures against payment by the Company of the amounts set forth in Section 1.1 by check, wire transfer or any combination thereof. Notwithstanding the foregoing, Holder acknowledges and agrees that, upon and as of the payment by the Company of the amounts set forth in Section 1.1, whether or not Holder has delivered and surrendered the originals of the Debentures to the Company, the Debentures shall be deemed null and void and cancelled in its entirety and Holder shall have no further rights with respect to or under the Debentures, whether such rights shall have accrued prior to or after the date hereof.

2. **Representations and Warranties.** Holder hereby represents, warrants and acknowledges as follows:

2.1. As of the date hereof, the aggregate principal amount outstanding under the Debentures is (\$ _____) and the aggregate accrued but unpaid interest outstanding under the Debentures is (\$ _____).

2.2. Holder is the sole record and beneficial owner of the Debentures. Upon payment of the amounts set forth in Section 1.1, the Company will acquire good and valid title to the Debentures, free and clear of all liens, security interests, pledges, claims and encumbrances of every kind, nature and description incurred or created by Holder.

2.3. Holder has the full right and power to enter into this Agreement, to perform its obligations hereunder and to consummate the transactions contemplated hereby. The execution, delivery and performance of this Agreement by Holder, and the consummation of the transactions contemplated hereby, (i) have been duly authorized by all requisite organizational action of Holder and (ii) do not and will not conflict with any law applicable to Holder or any of its properties or assets or any provisions of Holder's organizational documents or contracts, agreements or other instrument to which Holder is a party or by which any of its properties or assets may be bound.

2.4. Holder is an experienced and sophisticated investor, having such knowledge and experience in business and financial matters and investing as to be able to protect its own interests and assess the risks and merits of the Redemption. Holder has independently determined the advisability of entering into this Agreement and is entering into this Agreement of its own volition, and is not relying on any representations or statements of the Company or its officers, directors, shareholders, employees, agents, attorneys and representatives except for those representations and statements expressly set forth herein.

2.5. Holder has had the opportunity to consult with counsel of its choice regarding the meaning and legal effect of this Agreement, and regarding the advisability of making the agreements provided for herein, and fully understands the same.

3. Release. The following release shall be effective upon the Company's payment of the amounts set forth in Section 1.1.

3.1. Other than the obligations, covenants, representations and warranties provided for in this Agreement, Holder, for itself and its predecessors, successors, agents and assigns (individually and collectively, the "**Releasing Parties**"), hereby waives, releases, and forever discharges Iteris and its predecessors, successors, assigns, officers, directors, shareholders, employees, agents, attorneys and representatives, past and present, (collectively, the "**Iteris Released Parties**") of and from any and all rights, claims, debts, liabilities, demands, obligations, promises, damages, causes of action and claims for relief of any kind, manner, nature and description, known or unknown, which any of the Releasing Parties have, may have had, might have asserted, may now have or assert, or may hereafter have or assert against the Iteris Released Parties, or any of them, related to or arising under the Redemption and Holder's purchase and ownership of the Debentures. Holder represents and warrants that it has not filed any claims, charges, complaints or actions against the Company and has not assigned or transferred to any person or entity any of the claims Holder is releasing in this Agreement.

3.2. The Releasing Parties acknowledge and agree that the foregoing release includes in its effect all claims that they do not know or suspect to exist in their favor as of the date hereof, and the Releasing Parties expressly waive any statute, legal doctrine or other similar limitation upon the effect of general releases. In particular, the Releasing Parties waive any and

all rights and benefits conferred upon them by Section 1542 of the California Civil Code, which states as follows:

A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.

4. Governing Law. This Agreement shall in all respects be interpreted, enforced, and governed by and under the internal laws of the State of Delaware, without giving effect to any choice of law or conflict of law principles.

5. Entire Agreement. This Agreement constitutes the entire agreement between the parties with respect to the subject matter and supersedes all prior oral or written communications, understandings and agreements with respect thereto.

6. Headings. The use of headings in this Agreement is merely for convenience and such headings shall not be used in construing any provisions of this Agreement.

7. Interpretation. Each party has had the opportunity to negotiate modifications to the language of this Agreement and agrees that, in any dispute regarding the interpretation or construction of this Agreement, no presumption shall operate in favor of or against any party by virtue of its role in drafting or not drafting the terms and conditions set forth herein.

8. Severability. If any part, term or provision of this Agreement is held by a court to be void or voidable, illegal, unenforceable, invalid or otherwise in conflict with law, (i) the remaining provisions or applications of this Agreement shall not be affected and the rights and obligations of the parties shall be construed and enforced as if this Agreement did not contain the particular term or provision held to be invalid and (ii) such provision shall be amended to conform as nearly as possible, and only to the extent required, to applicable law.

9. Counterparts. This Agreement may be executed in several counterparts, each of which shall be deemed to be an original, and all such counterparts together shall constitute but one and the same instrument. A photocopy or facsimile signature may be used as an original.

[Signature Page Follows]

IN WITNESS WHEREOF, the undersigned have executed this Agreement to be effective as of the date first indicated above.

Iteris, Inc.

[]

By: _____

By: _____

Name: _____

Name: _____

Title: _____

Title: _____

Schedule for Exhibit 10.3

Iteris, Inc. entered into a Debenture Redemption Agreement with the following Holders, each substantially identical to this Exhibit 10.3 except as noted below:

Holder	Principal Amount of Debenture(s)	Redemption Price	Principal Outstanding	Accrued But Unpaid Interest
Lloyd I. Miller, III	\$ 500,000.00 680,000.00	\$ 1,150,500.00	\$ 1,180,000.00	\$ 5,222.95
Lloyd I. Miller Trust A-4	\$ 500,000.00 \$ 1,320,000.00	\$ 1,774,500.00	\$ 1,820,000.00	\$ 8,055.74
Milfam I, L.P.	\$ 500,000.00 \$ 1,180,000.00	\$ 1,638,000.00	\$ 1,680,000.00	\$ 7,436.07
Milfam II, L.P.	\$ 500,000.00	\$ 487,500.00	\$ 500,000.00	\$ 2,213.11

DEBENTURE REDEMPTION AGREEMENT

This Debenture Redemption Agreement ("***Agreement***") is entered into as of January 9, 2009 by and between ("***Holder***") and Iteris, Inc. ("***Iteris***" or the "***Company***").

RECITALS

WHEREAS, Holder holds a 6% Convertible Debenture dated May 19, 2004 in the principal amount of \$ (the "***Debenture***"); and

WHEREAS, the parties hereto have reached certain agreements with respect to the redemption of the above-described debenture.

NOW, THEREFORE, in consideration of the foregoing and the mutual promises and agreements contained herein, the sufficiency of which is hereby acknowledged, the parties hereto agree as follows:

1. **Debenture Redemption.**

1.1. The Company agrees to redeem from Holder, and Holder agrees to sell back to the Company, the Debenture for a payment of (\$) (the "***Redemption Price***"). In addition to the payment of the Redemption Price, the Company shall pay at the Closing (as defined below) all accrued but unpaid interest on the Debenture as of the date of Closing.

1.2. The redemption of the Debenture (the "***Redemption***") shall take place at the offices of Dorsey & Whitney LLP, 38 Technology Drive, Suite 100, Irvine, California 92618, at 1:00 P.M. Pacific Time on January 9, 2009, or at such other time and place as the Company and Holder mutually agree orally or in writing (which time and place are designated as the "***Closing***"). At the Closing, Holder shall deliver to the Company the original of the Debenture against payment by the Company of the amounts set forth in Section 1.1 by check, wire transfer or any combination thereof. Notwithstanding the foregoing, Holder acknowledges and agrees that, upon and as of the payment by the Company of the amounts set forth in Section 1.1, whether or not Holder has delivered and surrendered the original of the Debenture to the Company, the Debenture shall be deemed null and void and cancelled in its entirety and Holder shall have no further rights with respect to or under the Debenture, whether such rights shall have accrued prior to or after the date hereof.

2. **Representations and Warranties.** Holder hereby represents, warrants and acknowledges as follows:

2.1. As of the date hereof, the principal amount outstanding under the Debenture is (\$) and the accrued but unpaid interest outstanding under the Debenture is (\$).

2.2. Holder is the sole record and beneficial owner of the Debenture. Upon payment of the amounts set forth in Section 1.1, the Company will acquire good and valid title to the Debenture, free and clear of all liens, security interests, pledges, claims and encumbrances of every kind, nature and description incurred or created by Holder.

2.3. Holder has the full right and power to enter into this Agreement, to perform its obligations hereunder and to consummate the transactions contemplated hereby. The execution, delivery and performance of this Agreement by Holder, and the consummation of the transactions contemplated hereby, (i) have been duly authorized by all requisite organizational action of Holder and (ii) do not and will not conflict with any law applicable to Holder or any of its properties or assets or any provisions of Holder's organizational documents or contracts, agreements or other instrument to which Holder is a party or by which any of its properties or assets may be bound.

2.4. Holder is an experienced and sophisticated investor, having such knowledge and experience in business and financial matters and investing as to be able to protect its own interests and assess the risks and merits of the Redemption. Holder has independently determined the advisability of entering into this Agreement and is entering into this Agreement of its own volition, and is not relying on any representations or statements of the Company or its officers, directors, shareholders, employees, agents, attorneys and representatives except for those representations and statements expressly set forth herein.

2.5. Holder has had the opportunity to consult with counsel of its choice regarding the meaning and legal effect of this Agreement, and regarding the advisability of making the agreements provided for herein, and fully understands the same.

3. Release. The following release shall be effective upon the Company's payment of the amounts set forth in Section 1.1.

3.1. Other than the obligations, covenants, representations and warranties provided for in this Agreement, Holder, for itself and its predecessors, successors, heirs, agents and assigns (individually and collectively, the "**Releasing Parties**"), hereby waives, releases, and forever discharges Iteris and its predecessors, successors, assigns, officers, directors, shareholders, employees, agents, attorneys and representatives, past and present, (collectively, the "**Iteris Released Parties**") of and from any and all rights, claims, debts, liabilities, demands, obligations, promises, damages, causes of action and claims for relief of any kind, manner, nature and description, known or unknown, which any of the Releasing Parties have, may have had, might have asserted, may now have or assert, or may hereafter have or assert against the Iteris Released Parties, or any of them, related to or arising under the Redemption and Holder's purchase and ownership of the Debenture. Holder represents and warrants that it has not filed any claims, charges, complaints or actions against the Company and has not assigned or transferred to any person or entity any of the claims Holder is releasing in this Agreement.

3.2. The Releasing Parties acknowledge and agree that the foregoing release includes in its effect all claims that they do not know or suspect to exist in their favor as of the date hereof, and the Releasing Parties expressly waive any statute, legal doctrine or other similar limitation upon the effect of general releases. In particular, the Releasing Parties waive any and

all rights and benefits conferred upon them by Section 1542 of the California Civil Code, which states as follows:

A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.

4. Governing Law. This Agreement shall in all respects be interpreted, enforced, and governed by and under the internal laws of the State of Delaware, without giving effect to any choice of law or conflict of law principles.

5. Entire Agreement. This Agreement constitutes the entire agreement between the parties with respect to the subject matter and supersedes all prior oral or written communications, understandings and agreements with respect thereto.

6. Headings. The use of headings in this Agreement is merely for convenience and such headings shall not be used in construing any provisions of this Agreement.

7. Interpretation. Each party has had the opportunity to negotiate modifications to the language of this Agreement and agrees that, in any dispute regarding the interpretation or construction of this Agreement, no presumption shall operate in favor of or against any party by virtue of its role in drafting or not drafting the terms and conditions set forth herein.

8. Severability. If any part, term or provision of this Agreement is held by a court to be void or voidable, illegal, unenforceable, invalid or otherwise in conflict with law, (i) the remaining provisions or applications of this Agreement shall not be affected and the rights and obligations of the parties shall be construed and enforced as if this Agreement did not contain the particular term or provision held to be invalid and (ii) such provision shall be amended to conform as nearly as possible, and only to the extent required, to applicable law.

9. Counterparts. This Agreement may be executed in several counterparts, each of which shall be deemed to be an original, and all such counterparts together shall constitute but one and the same instrument. A photocopy or facsimile signature may be used as an original.

[Signature Page Follows]

IN WITNESS WHEREOF, the undersigned have executed this Agreement to be effective as of the date first indicated above.

Iteris, Inc.

[]

By: _____

By: _____

Name: _____

Name: _____

Title: _____

Title: _____

Schedule for Exhibit 10.4

Iteris, Inc. entered into a Debenture Redemption Agreement with the following Holders, each substantially identical to this Exhibit 10.4 except as noted below:

<u>Holder</u>	<u>Principal Amount of Debenture</u>	<u>Redemption Price</u>	<u>Principal Outstanding</u>	<u>Accrued But Unpaid Interest</u>
Irvin R. Kessler	\$ 1,000,000.00	\$ 980,000.00	\$ 1,000,000.00	\$ 1,479.45
Provident Premier Master Fund Ltd.	\$ 500,000.00	\$ 490,000.00	\$ 500,000.00	\$ 737.70

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Abbas Mohaddes, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Iteris, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 12, 2009

/s/ ABBAS MOHADDES
Abbas Mohaddes
Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, James S. Miele, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Iteris, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 12, 2009

/s/ JAMES S. MIELE

James S. Miele

Chief Financial Officer

(Principal Financial and Accounting Officer)

**CERTIFICATION PURSUANT TO
18 U.S.C. §1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Iteris, Inc. (the "Company") on Form 10-Q for the quarter ended December 31, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Abbas Mohaddes, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ ABBAS MOHADDES

Abbas Mohaddes
Chief Executive Officer

February 12, 2009

A signed original of this written statement required by Section 906, or any other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. §1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Iteris, Inc. (the "Company") on Form 10-Q for the quarter ended December 31, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James S. Miele, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ JAMES S. MIELE

James S. Miele
Chief Financial Officer

February 12, 2009

A signed original of this written statement required by Section 906, or any other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.
