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, 2005

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.)
1515 South Manchester Avenue **Anaheim, California** (Address of principal executive office)	**92802** (Zip Code)

(714) 774-5000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ **No** ☐

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

Large accelerated filer ☐ **Accelerated filer** ☐ **Non-accelerated filer** ☒

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 6, 2006, the registrant had 28,624,803 shares of common stock outstanding.

ITERIS, INC.
Quarterly Report on Form 10-Q
For the Three and Nine Months Ended December 31, 2005

Table of Contents

Unless otherwise indicated in this report, the “Company,” “we,” “us” and “our” collectively refer to Iteris, Inc. (formerly known as Iteris Holdings, Inc. and Odetics, Inc.) and its subsidiary, Meyer, Mohaddes Associates, Inc.

AutoVue™, Iteris® and Vantage® 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.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	December 31, 2005	March 31, 2005
ASSETS		
Current assets:		
Cash	$ —	$ 46
Trade accounts receivable, net of allowance for doubtful accounts of $429 and $239 at December 31, 2005 and March 31, 2005, respectively	8,840	8,866
Costs and estimated earnings in excess of billings on uncompleted contracts	2,429	2,086
Inventories, net of reserve for inventory obsolescence of $680 and $514 at December 31, 2005 and March 31, 2005, respectively	2,652	4,344
Deferred income taxes	292	101
Prepaid expenses and other current assets	560	384
Total current assets	14,773	15,827
Property and equipment, net	1,313	1,103
Deferred income taxes	840	559
Intangible assets, net of accumulated amortization of $224 and $114 at December 31, 2005 and March 31, 2005, respectively	588	698
Goodwill	27,774	27,774
Other assets	514	695
Total assets	$ 45,802	$ 46,656
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	$ 2,890	$ 3,936
Accrued payroll and related expenses	3,601	3,007
Accrued liabilities	1,180	790
Billings in excess of costs and estimated earnings on uncompleted contracts	813	944
Revolving line of credit	1,389	945
Current portion of long-term debt	1,607	4,008
Total current liabilities	11,480	13,630
Non-current payroll related liability	101	330
Deferred compensation plan liability	760	772
Deferred gain on sale of building	520	733
Long-term debt and capital lease obligation	2,740	1,319
Convertible debentures, net	9,151	8,996
Total liabilities	24,752	25,780
Commitments and contingencies		
Redeemable common stock, 1,219 shares issued and outstanding at December 31, 2005 and March 31, 2005	3,414	3,414
Stockholders' equity:		
Preferred stock, $1.00 par value, 2,000 shares authorized, none issued and outstanding at December 31, 2005 and March 31, 2005	—	—
Common stock, $0.10 par value, 50,000 shares authorized, 27,373 and 27,090 shares issued and outstanding at December 31, 2005 and March 31, 2005, respectively	2,737	2,709
Additional paid-in capital	126,693	126,534
Deferred stock-based compensation	(194)	(925)
Common stock held in trust, 311 shares at December 31, 2005 and March 31, 2005	(374)	(374)
Treasury stock	—	(1)
Notes receivable from employees	(45)	(45)
Accumulated deficit	(111,181)	(110,436)
Total stockholders' equity	17,636	17,462
Total liabilities and stockholders' equity	$ 45,802	$ 46,656

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 MonthsEnded December 31,	
	2005	**2004**	**2005**	**2004**
Net sales and contract revenues:				
Net sales	**$ 7,276**	$ 7,576	**$ 22,776**	$ 22,130
Contract revenues	**4,907**	4,138	**14,201**	12,785
Total net sales and contract revenues	**12,183**	11,714	**36,977**	34,915
Costs and expenses:				
Cost of sales	**3,893**	4,000	**11,866**	11,878
Cost of contract revenues	**3,269**	2,670	**9,138**	8,349
Gross profit	**5,021**	5,044	**15,973**	14,688
Operating expenses:				
Selling, general and administrative	**3,555**	4,002	**11,194**	10,803
Research and development	**1,153**	1,055	**4,176**	2,719
Stock-based compensation	**103**	11,490	**626**	11,490
Disposal of fixed assets	**—**	422	**—**	422
Acquired in-process research and development	**—**	25	**—**	140
Deferred compensation plan	**(90)**	—	**(12)**	—
Amortization of intangible assets	**37**	44	**110**	78
Total operating expenses	**4,758**	17,038	**16,094**	25,652
Operating income (loss)	**263**	(11,994)	**(121)**	(10,964)
Non-operating income (expense):				
Other income (expense), net	**(6)**	60	**32**	1,040
Interest expense, net	**(377)**	(298)	**(1,087)**	(838)
Loss before income taxes and minority interest	**(120)**	(12,232)	**(1,176)**	(10,762)
Income tax (expense) benefit	**256**	51	**431**	(24)
Minority interest in earnings of subsidiary	**—**	(52)	**—**	(485)
Net income (loss)	**$ 136**	$ (12,233)	**$ (745)**	$ (11,271)
Earnings (loss) per common share:				
Basic	**$ 0.00**	$ (0.44)	**$ (0.03)**	$ (0.45)
Diluted	**$ 0.00**	$ (0.44)	**$ (0.03)**	$ (0.45)
Weighted average common shares outstanding:				
Basic	**28,246**	27,614	**28,138**	25,168
Diluted	**32,700**	27,614	**28,138**	25,168

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, 2005	Nine Months Ended December 31, 2004
Cash flows from operating activities		
Net loss	$ **(745)**	$ (11,271)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	**506**	604
Write-off of in-process research and development	—	140
Minority interest in earnings of subsidiary	—	485
Amortization of deferred gain on sale—leaseback transaction	**(213)**	(535)
Amortization of intangible assets	**110**	78
Amortization of debt discount	**155**	132
Amortization of deferred financing costs	**103**	83
Stock-based compensation	**626**	11,490
Loss on disposal of fixed assets	—	422
Change in deferred tax assets	**(472)**	(172)
Changes in operating assets and liabilities:		
Accounts receivable	**26**	(53)
Net costs and estimated earnings in excess of billings	**(474)**	442
Inventories	**1,692**	71
Prepaid expenses and other assets	**(98)**	(335)
Accounts payable and accrued expenses	**(275)**	(544)
Deferred revenue	—	(226)
Net cash provided by operating activities	**941**	811
Cash flows from investing activities		
Purchases of property and equipment	**(716)**	(425)
Notes receivable from sale of business units	—	50
Net cash used in investing activities	**(716)**	(375)
Cash flows from financing activities		
Proceeds from borrowings on line of credit, net	**444**	450
Proceeds from long-term debt	—	5,000
Payments on long-term debt and capital lease obligations	**(980)**	(814)
Costs from issuance of common stock	—	(97)
Proceeds from issuance of convertible debentures	—	9,479
Purchase of Iteris Subsidiary Series A preferred stock	—	(17,543)
Proceeds from stock option and warrant exercises	**265**	494
Net cash used in financing activities	**(271)**	(3,031)
Decrease in cash	**(46)**	(2,595)
Cash at beginning of period	**46**	2,612
Cash at end of period	$ **—**	$ 17
Supplemental cash flow information:		
Cash paid (received) during the period:		
Interest	$ **795**	$ 464
Income taxes	**(2)**	583
Supplemental schedule of non-cash investing and financing activities:		
Increase in promissory note to landlord to settle lease obligations	—	432
Acquisition of minority interest of the Iteris Subsidiary		
Intangible assets	—	813
Goodwill	—	19,121
Reduction of minority interest	—	753
Issuance of warrants in connection with Debenture and Warrant Purchase Agreement	—	1,100
Conversion of convertible debt to equity	—	250

See accompanying notes to unaudited condensed consolidated financial statements.

ITERIS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2005

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

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

Basis of Presentation

The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Securities and Exchange Commission ("SEC") Form 10-Q and Article 10 of SEC Regulation S-X. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary to present fairly the consolidated financial position of the Company as of December 31, 2005, the consolidated results of operations for the three and nine month periods ended December 31, 2005, and 2004, and the consolidated cash flows for the nine month periods ended December 31, 2005, and 2004. 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 month periods ended December 31, 2005, 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, 2005, which was filed with the SEC on July 14, 2005.

Use of Estimates

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

Revenue Recognition

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

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

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

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

Concentration of Credit Risk

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

Fair Values of Financial Instruments

The fair values of cash and cash equivalents, receivables, inventories, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity. The fair values of line of credit agreements and long-term debt approximate carrying value because the related rates of interest approximate current market rates. The fair value of convertible debentures approximates carrying value because the effective interest rate, taking into account recorded debt discounts, approximates current market rates. Prior to December 31, 2005, the fair value of redeemable common stock approximated carrying value since these shares were not tradable in any public equity markets. At December 31, 2005, the estimated fair value of the redeemable shares was $2.9 million, based on the closing price of the Company's common stock on that date.

Inventories

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

Property and Equipment

Property and equipment are recorded at cost and are depreciated principally by the double declining balance 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* ("SFAS 142"), goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis in the Company's fourth fiscal quarter or more frequently if indicators of impairment exist, of which none have been identified. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of the Company's reporting units with each respective reporting unit's carrying amount, including goodwill. The fair value of reporting units is generally determined using the income approach. If the carrying amount of a reporting unit exceeds the reporting unit's fair value, the second step of the goodwill impairment test is performed to determine the amount of any impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

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

Income Taxes

The Company utilizes the liability method of accounting for income taxes as set forth in SFAS No. 109, *Accounting for Income Taxes.* 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

The Company accounts for stock-based employee compensation arrangements in accordance with Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock-Issued to Employees* ("APB 25") and related interpretations, and complies with the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"), and SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure* ("SFAS 148"). Under APB 25, compensation expense is recognized based on the difference, if any, on the date of the grant between the fair value of the Company's stock and the amount the employee must pay to acquire the stock.

In accordance with the requirements of the disclosure-only alternative of SFAS 123 and SFAS 148, set forth below are the assumptions used and the pro forma statement of operations data of the Company, which gives effect to valuing stock-based awards to employees using the Black-Scholes option pricing model instead of the guidelines provided by APB 25. Among other factors, the Black-Scholes model considers the expected life of the option and the expected volatility of the Company's stock price in arriving at an option valuation.

The per share fair value of stock options granted in connection with stock option plans has been estimated with the following weighted average assumptions:

	Three and Nine Months Ended December 31, 2005	2004
Dividend rate	**0.0**	0.0
Expected life – years	**7.0**	7.0
Risk-free interest rate	**5.5**	4.5
Volatility of common stock	**0.5**	0.5

For purposes of pro forma disclosures, the estimated fair value of stock options is amortized to expense over the vesting period of the options. The Company's pro forma information is as follows:

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004	Nine Months Ended December 31, 2005	Nine Months Ended December 31, 2004
	(In thousands, except per share amounts)			
Net income (loss) – as reported	**$ 136**	$ (12,233)	**$ (745)**	$ (11,271)
Add: Stock-based compensation expense included in net income (loss) – as reported	**103**	11,490	**626**	11,490
Deduct: Stock-based compensation expense under fair value method	**(177)**	(12,163)	**(912)**	(12,443)
Net income (loss) – pro forma	**$ 62**	$ (12,906)	**$ (1,031)**	$ (12,224)
Basic and diluted earnings (loss) per share – as reported	**$ 0.00**	$ (0.44)	**$ (0.03)**	$ (0.45)
Basic and diluted earnings (loss) per share – pro forma	**$ 0.00**	$ (0.47)	**$ (0.04)**	$ (0.49)

Research and Development Expenditures

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

Shipping and Handling Costs

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

Warranty

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

Repair and Maintenance Costs

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

Reclassifications

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

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, *Inventory Costs* ("SFAS 151"), which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS 151 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Management does not believe the adoption of SFAS 151 will have a material impact on the Company's financial statements.

On December 16, 2004, the FASB issued SFAS No.123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), which replaces SFAS 123, supersedes APB 25, and amends SFAS No. 95, *Statement of Cash Flows* ("SFAS 95"). Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values (i.e., pro forma disclosure is no longer an alternative to financial statement recognition). In accordance with SEC Release No. 33-8568, SFAS 123R will be effective for the Company beginning April 1, 2006. The Company is currently assessing the impact of SFAS 123R. As of the date of this filing, no decisions have been made as to whether the Company will apply the modified prospective or retrospective transition method of application; therefore, the effect of adoption of SFAS 123R cannot be determined at this time.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* ("SFAS 154"). SFAS 154 requires retroactive application of a voluntary change in accounting principle to prior period financial statements unless it is impracticable. SFAS 154 also requires that a change in method of depreciation, amortization or depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is affected by a change in accounting principle. SFAS 154 replaces APB Opinion No. 20, *Accounting Changes* ("APB 20"), and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements* ("SFAS 3"). The Company is required to adopt the provisions of SFAS 154 in its fiscal year ending March 31, 2007. Management is presently evaluating what effect the adoption of the provisions of SFAS 154 will have on the Company's consolidated financial statements.

2. Supplemental Financial Information

Inventories

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

	December 31, 2005	March 31, 2005
	(In thousands)	
Materials and supplies	**$ 2,091**	$ 3,204
Work in process	**280**	558
Finished goods	**281**	582
	$ 2,652	$ 4,344

Goodwill and Identifiable Intangible Assets

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

	December 31, 2005		March 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
	(In thousands)			
Developed technology	**$ 495**	**$ (156)**	$ 495	$ (78)
Patents	**317**	**(68)**	317	(36)
Total	**$ 812**	**$ (224)**	$ 812	$ (114)

Amortization expense for intangible assets subject to amortization was $37,000 and $110,000 for the three and nine month periods ended December 31, 2005, respectively, and $44,000 and $78,000 for the three and nine month periods ended December 31, 2004, respectively. Future estimated amortization expense for the remainder of the current fiscal year, the next four fiscal years and thereafter is as follows:

Fiscal Year Ending March 31:	
(In thousands)	
Remainder of 2006	$ 37
2007	147
2008	147
2009	147
2010	58
Thereafter	52
	$ 588

At December 31, 2005, goodwill of $27.8 million was comprised of $18.0 million associated with the October 2004 merger of the Iteris Subsidiary (Note 3); $9.6 million associated with the acquisitions of the Rockwell International Transportation Systems Group, Meyer Mohaddes Associates and the Viggen Systems Consulting Group; and $200,000 associated with the purchase of the assets of Mil-Lektron, a complementary product to the Company's Vantage video detection business.

Warranty Reserve Activity

The following table presents activity in accrued warranty obligations:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2005	2004	2005	2004
	(In thousands)			
Balance at beginning of period	**$ 441**	$ 400	**$ 326**	$ 192
Additions charged to cost of sales	**80**	61	**345**	502
Warranty claims	**(92)**	(129)	**(242)**	(362)
Balance at end of period	**$ 429**	$ 332	**$ 429**	$ 332

Earnings (Loss) Per Share

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

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004	Nine Months Ended December 31, 2005	Nine Months Ended December 31, 2004
	(In thousands, except per share amounts)			
Numerator:				
Net income (loss)	**$ 136**	$ (12,233)	**$ (745)**	$ (11,271)
Denominator:				
Weighted average common shares used in basic computation	**28,246**	27,614	**28,138**	25,168
Dilutive stock options	**3,725**	—	**—**	—
Dilutive warrants	**729**	—	**—**	—
Weighted average common shares used in dilutive computation	**32,700**	27,614	**28,138**	25,168
Basic and diluted earnings (loss) per share	**$ 0.00**	$ (0.44)	**$ (0.03)**	$ (0.45)

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

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004	Nine Months Ended December 31, 2005	Nine Months Ended December 31, 2004
	(In thousands)			
Stock options	—	4,681	**3,970**	4,662
Warrants	—	852	**824**	844
Convertible debentures	**2,729**	2,798	**2,729**	2,798

3. Merger of the Company and the Iteris Subsidiary

On May 28, 2004, in order to simplify the Company's capital structure and facilitate the merger of the Iteris Subsidiary into the Company, the Company completed the purchase of all of the outstanding shares of the Series A preferred stock of the Iteris Subsidiary (the "Series A preferred stock"), which were held by DaimlerChrysler Ventures GmbH ("DCV") and Hockenheim Investment Pte. Ltd. ("Hockenheim"), at a purchase price of $5.61 per share or an aggregate purchase price of approximately $17.5 million in cash. The purchase price represented the stated redemption value of the Series A preferred stock. The purchase of the shares was financed primarily with a $10.1 million convertible debenture financing completed in May 2004 with a group of accredited investors, in addition to a $5.0 million senior credit facility arranged through a bank and $2.4 million in cash (Note 4). In addition, the Company acquired all of the 547,893 shares of common stock of the Iteris Subsidiary held by DCV in exchange for the issuance of 1,219,445 shares (the "Exchange Shares") of the Company's Class A common stock (now known as the Company's common stock), which was valued at $3.4 million at the date of issuance. The fair value of the Company's common stock issued in the transaction was based on the quoted market price of the Company's common stock on the OTC Bulletin Board averaged over a five-day period. The purchase and exchange of the shares were made pursuant to a Stock Purchase and Exchange Agreement dated March 31, 2004, by and among the Company, the Iteris Subsidiary, DCV and Hockenheim (the "Purchase and Exchange Agreement").

On June 30, 2004, the Company and certain minority stockholders of the Iteris Subsidiary (including certain officers and directors) entered into an exchange agreement whereby an aggregate of 1,319,541 shares of common stock of the Iteris Subsidiary were exchanged for 2,639,082 shares of the Company's newly issued common stock valued at $8.6 million at the date of issuance. The fair value of the Company's stock issued in the transaction was based on the quoted market price of the Company's common stock on the OTC Bulletin Board averaged over a five-day period. The effect of this exchange was to reduce the residual minority interest in the Iteris Subsidiary to 8.1%.

On October 22, 2004, the Iteris Subsidiary was merged into the Company. The remaining 8.1% minority interest in the

Iteris Subsidiary (consisting of 1,228,981 shares of common stock of the Iteris Subsidiary) was converted to 2,457,962 shares of the Company's common stock valued at $7.6 million at the merger date. Immediately following the merger, the Company converted all of its outstanding Class B common stock (921,917 shares) into 1,014,108 shares of its common stock (formerly designated as Class A common stock). The exchange ratio used in the conversion was determined by the Company's Board of Directors. The fair value of the Company's common stock issued in the transaction was based on the quoted market price of the Company's common stock on the OTC Bulletin Board averaged over a five-day period. In October 2004, the Company also amended its certificate of incorporation to (a) change the voting rights of its Class A common stock from one-tenth to one vote per share, (b) remove the ability to issue any further shares of Class B common stock, and (c) rename its Class A common stock to common stock. As a result, the Company currently has only one class of common stock outstanding, the common stock.

In connection with the merger, the Company assumed all outstanding options and warrants to purchase shares of common stock of the Iteris Subsidiary that were outstanding immediately prior to the merger, whether vested or unvested, together with the Iteris Subsidiary's 1998 Stock Incentive Plan (the "Option Plan"). Each such option and warrant assumed by the Company continues to have, and be subject to, the same terms and conditions as were applicable immediately prior to the merger, provided that (A) such option or warrant is exercisable for that number of whole shares of the Company's common stock equal to the product of the number of shares of the Company's common stock that were issuable upon exercise of such assumed option or warrant immediately prior to the merger multiplied by two (the "Exchange Ratio") rounded down to the nearest whole number of shares and (B) the per share exercise price for the shares of the Company's common stock issuable upon exercise of such assumed option or warrant is equal to the quotient determined by dividing the exercise price per share at which such option or warrant was exercisable immediately prior to the merger by the Exchange Ratio (rounded up to the nearest whole cent). As a result, options and warrants to purchase approximately 3.1 million shares and 327,000 shares, respectively, of common stock of the Iteris Subsidiary assumed in the merger became options and warrants to purchase approximately 6.1 million and 655,000 shares of common stock of the Company, respectively. The weighted-average exercise prices of the assumed options and warrants were $1.09 and $2.32, respectively. Stock-based compensation expense of $11.3 million was recorded in connection with the assumption and exchange of vested Iteris Subsidiary stock options for stock options immediately exercisable into the Company's common stock based on the difference between the fair market value of the Company's common stock on the October 22, 2004, merger date and the exercise price of the modified stock option. Additionally, the Company recorded approximately $1.4 million in deferred compensation related to the assumption of unvested stock options to purchase common stock of the Iteris Subsidiary. Deferred compensation is being amortized to stock-based compensation expense as the options vest. The Company also recorded $1.1 million of goodwill and additional paid-in-capital in connection with the 655,000 vested warrants assumed in the merger and acquisition of the Iteris Subsidiary. The $1.1 million value was based on the difference between the fair market value of the Company's common stock on the October 22, 2004, merger date and the modified exercise price of the assumed warrants.

The excess of the purchase price over the proportionate amount of minority interest acquired was allocated to acquired intangible assets based on the estimated fair values with the residual allocated to goodwill. Accordingly, the Company recorded goodwill of $18.0 million, which represents the excess of the purchase price over the fair value of the proportionate identifiable net assets acquired. The estimated fair value of the intangible assets was determined using the income method and discounting future expected returns. The estimated useful life for each of the acquired intangible assets is provided below:

Patents	7 years
Developed technology	5 years

The following table summarizes the fair values of the assets acquired and liabilities assumed and the allocation of the purchase price at the date of acquisition (in thousands):

Acquisition costs:		
Issuance of common stock	$	18,617
Assumption of Iteris Subsidiary warrants		1,114
Purchase of Iteris Subsidiary Series A preferred stock		17,543
Acquisition costs		80
Total acquisition costs	$	37,354
Purchase price allocation:		
Fair value of 41% of Iteris Subsidiary		
Patents	$	318
Developed technology		495
Acquired in-process research and development		140
Deferred tax liabilities		(360)
Reduction of minority interest		18,794
Goodwill (not deductible for tax purposes)		17,967
Total purchase price allocation	$	37,354

On October 22, 2004, in connection with the Company's merger with the Iteris Subsidiary, the Chief Executive Officer of the Iteris Subsidiary, Mr. Jack Johnson, was promoted to President and Chief Executive Officer of the Company, replacing Mr. Gregory Miner. This merger triggered certain obligations under the Company's change-in-control agreement with Mr. Miner. Accordingly, the Company recorded approximately $807,000 in severance expense, which included $57,000 for related payroll taxes, as a charge to earnings for the year ended March 31, 2005. The severance amount is being paid to Mr. Miner in bi-weekly installments over a 30 month period that began in October 2004. Mr. Miner is not required to render any services to the Company in connection with this agreement.

4. Revolving Line of Credit and Long-Term Debt

Revolving Line of Credit

Effective August 1, 2005, the Company renewed its line of credit agreement with its primary bank. This line of credit agreement expires on July 31, 2006 and provides for borrowings of up to $5.0 million. Under the terms of this agreement, the Company may borrow against its eligible accounts receivable and the value of its eligible inventory, as defined in the credit agreement. Interest on borrowed amounts is payable monthly at the current stated prime rate plus 3.0%. Additionally, the Company is obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeds the average daily principal balance during the preceding month.

There are no monthly collateral management fees and no pre-payment or early termination fees. On December 31, 2005, the available credit under this line of credit agreement was $3.3 million, of which $1.9 million was unused.

Long-Term Debt

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

	December 31 2005	March 31, 2005
	(In thousands)	
Convertible debentures, net	$ 9,151	$ 8,996
Bank term note	3,021	3,958
Promissory note to landlord	1,292	1,292
4% note payable	34	67
Capital lease obligation	—	10
	13,498	14,323
Less current portion	(1,607)	(4,008)
	$ 11,891	$ 10,315

Convertible Debentures, Net. In order to finance the purchase of the Iteris Subsidiary Series A preferred stock (Note 3), the Company entered into a Debenture and Warrant Purchase Agreement dated May 19, 2004, with a group of accredited investors, which included certain officers of the Company, pursuant to which the Company sold and issued subordinated convertible debentures in the aggregate original principal amount of $10.1 million. In connection with the issuance of the debentures, the Company issued warrants to purchase an aggregate of 639,847 shares of its common stock, the value of which was recorded as a debt discount against the face amount of the debentures on the date of issuance and is being amortized to interest expense over the term of the convertible debentures.

The debentures are due in full on May 19, 2009, provide for 6.0% annual interest, payable quarterly, and are convertible into the Company's common stock at an initial conversion price of $3.61 per share, subject to certain adjustments, including adjustments for dilutive issuances. From May 19, 2007 until May 18, 2008, the debentures may be redeemed by the Company, at its option, at 120% of the principal amount; and from May 19, 2008, until the maturity date, the debentures may be redeemed at 110% of the principal amount. As of December 31, 2005, $250,000 of convertible debentures had been converted into 69,252 shares of common stock leaving $9.9 million of the originally issued convertible debentures outstanding at December 31, 2005.

Bank Term Note. Concurrent with the issuance of the convertible debentures, the Iteris Subsidiary entered into a $5.0 million term note payable with a bank. This note was assumed by the Company in October 2004. The proceeds from the note were used to purchase the Series A preferred stock of the Iteris Subsidiary (Note 3). The note is due on May 27, 2008, and provides for monthly principal payments of approximately $104,000. Interest accrues at the current stated prime rate plus 0.25% (7.50% at December 31, 2005).

Both the term note payable and the line of credit are held by one bank under the same credit agreement and are secured by substantially all of the assets of the Company. At March 31, 2005, the Company failed to meet certain financial covenants under the previous credit agreement. Accordingly, the entire March 31, 2005 balance of the bank term note is presented as a current liability in the accompanying condensed consolidated balance sheet.

Promissory Note to Landlord. The Company has a $1.3 million unsecured promissory note payable to its landlord. Under the terms of the note agreement, interest is payable quarterly and accrues at a rate of prime plus 2.0% (9.25% at December 31, 2005). Beginning on October 1, 2006, the Company is required to make four equal quarterly payments of principal and accrued interest. All outstanding accrued interest and principal becomes payable in full on July 2, 2007.

4% Note Payable. On October 9, 2003, the Company entered into a $126,000 unsecured note payable agreement to settle trade payables. The note is secured by the equipment related to the payable. The note bears interest at 4.0%, is payable in monthly installments of $4,000 for 36 months and becomes payable in full on October 20, 2006.

Scheduled aggregate maturities of long-term debt principal as of December 31, 2005 were as follows:

Year Ending March 31, (In thousands)		
Remainder of 2006	$	324
2007		1,918
2008		1,896
2009		208
2010		9,850
	$	14,196

5. Commitments and Contingencies

Litigation and Other Contingencies

On June 29, 2004, a supplier to Mariner Networks, Inc., the Company's former subsidiary, filed a complaint in Orange County Superior Court against the Company alleging various breaches of written contract claims arising out of alleged purchase orders. The plaintiff in this lawsuit seeks monetary damages aggregating approximately $850,000 plus attorney fees and related costs. Discovery has commenced, and a trial date has been set for May 2006. The Company intends to vigorously defend itself against these allegations. Due to the uncertainty of the outcome, the Company has not recorded any amounts in the accompanying condensed consolidated financial statements in connection with this matter; however, should the ultimate resolution of this claim be unfavorable, it could have an adverse material impact on the Company's consolidated financial position, results of operations and cash flows.

In June 2004, the Company received $949,000 in cash as part of a settlement between Rockwell International and the Michigan Department of Transportation, pursuant to which the Company was a third party beneficiary. This amount is reflected in other income in the condensed consolidated statement of operations for the nine month period ended December 31, 2004.

From time to time, the Company has been involved in litigation relating to claims arising out of its operations in the normal course of business. The Company currently is not a party to any legal proceedings except as described above, 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. In addition to the lawsuit mentioned above, 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, except as described above, 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, 2005, including the lease for the Company's Anaheim facilities were as follows:

Fiscal Year Ending March 31, (In thousands)		
Remainder of 2006	$	**349**
2007		**1,288**
2008		**792**
2009		**103**
2010		**85**
Thereafter		**43**
Total	$	**2,660**

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

The following table sets forth selected unaudited financial information for the Company's reportable segments for the three and nine month periods ended December 31, 2005 and 2004:

	Roadway Sensors	Vehicle Sensors	Transportation Systems	Total
		(In thousands)		
Three Months Ended December 31, 2005				
Product revenue from external customers	$ 5,234	$ 1,401	$ —	$ 6,635
Service and other revenue from external customers	—	641	4,907	5,548
Depreciation and amortization	35	52	55	142
Segment income (loss)	709	(558)	411	562
Three Months Ended December 31, 2004				
Product revenue from external customers	$ 5,654	$ 1,177	$ —	$ 6,831
Service and other revenue from external customers	—	745	4,138	4,883
Depreciation and amortization	30	30	107	167
Segment income (loss)	1,080	(280)	400	1,200
Nine Months Ended December 31, 2005				
Product revenue from external customers	$ 16,380	$ 4,600	$ —	$ 20,980
Service and other revenue from external customers	—	1,796	14,201	15,997
Depreciation and amortization	98	134	206	438
Segment income (loss)	2,372	(1,866)	1,507	2,013
Nine Months Ended December 31, 2004				
Product revenue from external customers	$ 16,897	$ 2,849	$ —	$ 19,746
Service and other revenue from external customers	—	2,384	12,785	15,169
Depreciation and amortization	85	84	300	469
Segment income (loss)	3,077	(974)	937	3,040

The following table reconciles segment income to consolidated loss before income taxes and minority interest:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
		(In thousands)		
Total income for reportable segments	**$ 562**	$ 1,200	**$ 2,013**	$ 3,040
Unallocated amounts:				
Corporate expenses and other income (expense), net	**(305)**	(13,134)	**(2,102)**	(12,964)
Interest expense, net	**(377)**	(298)	**(1,087)**	(838)
Loss before income taxes and minority interest	**$ (120)**	$ (12,232)	**$ (1,176)**	$ (10,762)

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, the status of our facilities and product development, and the impact of pending litigation. These statements are not guarantees of future performance and are subject to certain risks and uncertainties which could cause 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 below, 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 leading provider of outdoor machine vision systems and sensors that optimize the flow of traffic and enhance driver safety. Using our proprietary software and ITS industry expertise, we provide video sensor systems and transportation management systems and traveler information and other engineering services to the ITS industry. We use our outdoor image recognition software expertise to develop proprietary algorithms for video sensor systems that improve vehicle safety and the flow of traffic. Using our knowledge of the ITS industry, we design and implement transportation management systems that help public agencies reduce traffic congestion and provide greater access to traveler information.

Our Vantage product is a video vehicle detection system that detects the presence of vehicles on roadways. Vantage systems are used at signalized intersections to enable a more efficient allocation of green signal time and are also used for incident detection and highway traffic data collection applications. We sell and distribute our Vantage products primarily to commercial customers and municipal agencies.

Our AutoVue Lane Departure Warning ("LDW") systems consist of a small windshield mounted sensor that uses proprietary software to detect and warn drivers of unintended lane departures. Approximately 20,000 production AutoVue units have been sold for truck platforms in the North American and European markets. Our AutoVue LDW systems are currently offered as an option on certain Mercedes, MAN, Freightliner and International trucks. In September 2003, we entered into an agreement with Valeo Schalter and Sensuren GmbH ("Valeo"), pursuant to which we granted Valeo the exclusive right to sell and manufacture our AutoVue LDW systems to the worldwide passenger car market in exchange for royalty payments for each AutoVue LDW unit sold. To date, royalty payments from Valeo have not been significant. Pursuant to this agreement, we also provide specific contract engineering services, technical marketing and sales support to Valeo to enable the launch of our LDW technology on three Infiniti platforms, the FX, M and Q, where the device is offered as part of the technology option package. Valeo is currently in negotiations to provide our LDW system to other passenger car OEMs; however, we cannot assure you that such negotiations will be successful. We plan to continue to provide technical marketing and sales support to Valeo in our efforts to win new OEM customers for the passenger car market as well as contract engineering services related to the possible launch of new Infiniti platforms that include our LDW system. We believe that AutoVue is a broad sensor platform that, through additional software development, may be expanded to incorporate additional safety and convenience features.

Our transportation management systems business 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 and other engineering for the implementation of transportation infrastructure and related communications systems, analysis and study related to goods movement and commercial vehicle operations, and parking systems designs. These services and systems are 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 was passed in August 2005, which provides for a significant increase in transportation funding over the next six years. Historically there have been significant delays between the passage of funding bills and the allocation of related funding to specific contracts. Accordingly, we cannot currently predict the impact that the passage of this bill will have on our transportation management systems business.

We currently operate in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. The Vehicle Sensors segment is comprised of all activities related to our AutoVue LDW systems for vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry.

Merger with Iteris Subsidiary

During our fiscal year ended March 31, 2005, we completed the merger of our Iteris Subsidiary into us. This merger included the following transactions:

- In May 2004, we repurchased all of the outstanding shares of Series A preferred stock of the Iteris Subsidiary for an aggregate purchase price of approximately $17.5 million in cash, and we purchased 548,000 shares of the Iteris Subsidiary common stock from DCV in consideration for the issuance of 1.2 million shares of our common stock. We financed the purchase price for the Iteris Subsidiary Series A preferred stock through the issuance of convertible debentures in the original principal amount of $10.1 million, a $5.0 million term note payable to our bank and $2.4 million in cash.

- In June 2004, we issued 2.6 million shares of our common stock valued at $8.6 million at the date of issuance in exchange for an aggregate of 1.3 million shares of common stock of the Iteris Subsidiary, which had the effect of reducing the residual minority interest in our Iteris Subsidiary to 8.1%.

- In October 2004, we merged the Iteris Subsidiary into us and the remaining minority interest in the Iteris Subsidiary (consisting of 1.2 million shares of common stock of the Iteris Subsidiary) was converted to 2.5 million shares of our common stock valued at $7.6 million at the merger date. Immediately following the merger, we converted all of our outstanding Class B common stock (922,000 shares) into 1.0 million shares of our common stock (formerly designated as Class A common stock). In connection with this merger, we also assumed all of the outstanding options and warrants to purchase common stock of the Iteris Subsidiary, which aggregated 6.1 million and 655,000 shares, respectively, of our common stock.

- In October 2004, we amended our certificate of incorporation to (a) change the voting rights of our Class A common stock from one-tenth to one vote per share, (b) remove the ability to issue any further shares of Class B common stock, and (c) rename our Class A common stock as common stock. As a result, we currently have only one class of common stock outstanding, the common stock.

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Conditions and Results of Operations is based on our unaudited condensed consolidated financial statements included herein, which have been prepared in accordance with U.S generally accepted accounting principles. 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 and the recoverability of long-lived assets and goodwill. We base these estimates on 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 amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

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

Revenue Recognition. We record product revenues and related costs of sales upon transfer of title, which is generally upon shipment or, if required, upon acceptance by the customer, provided that we believe collectibility of the net sales amount is reasonably assured. 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 using the percentage of completion method of accounting based on the relationship of costs incurred 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 recognized costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when their realization is reasonably assured.

In addition to product and contract revenues, we derive revenue from technology access fees, the provision of specific non-recurring contract engineering services related to our AutoVue LDW system, and royalties related to unit sales of our AutoVue LDW systems by our strategic partner Valeo to the passenger car market. Technology access fee revenues are recognized evenly over the period in which they are earned. Non-recurring contract engineering revenues are recognized in the period in which the related services are performed. Royalty revenues are recorded based on unit sales of our products by Valeo and are recognized in the period in which such sales occur. Technology access fee revenues, contract engineering revenues and royalty revenues are included in net sales in the accompanying condensed consolidated statements of operations.

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

Accounts Receivable. We estimate the collectibility of customer receivables on an ongoing basis by periodically reviewing invoices outstanding greater than a certain period of time. We have recorded reserves for receivables deemed to be at risk for collection as well as a general reserve based on our historical collections experience. A considerable amount of judgment is required in assessing the ultimate realization of trade receivables, including the current credit-worthiness of each customer. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make required payments, additional allowances may be required that could adversely affect our operating results.

Inventory. Inventories consist of finished goods, work-in-process and raw materials and are stated at the lower of cost or market. We provide reserves for potentially excess and obsolete inventory. In assessing the ultimate realization of inventories, we make judgments as to future demand requirements and compare that with the current or committed inventory levels. Reserves are established for inventory levels that exceed future demand. It is possible that reserves over and above those already established may be required in the future if market conditions for our products deteriorate.

Goodwill. Goodwill is tested for impairment annually in the fourth fiscal quarter at the reporting unit level unless a change in circumstances indicates that more frequent impairment analysis is required. Impairment, if any, is measured based on the estimated fair value of the reporting units with the recorded goodwill. Fair value is determined by using the income approach methodology of valuation which utilizes discounted cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the discounted cash flow method of valuation. In estimating future cash flows, we generally use the financial assumptions in our current budget and our current strategic plan, subject to modification as considered necessary, including sales and expense growth rates and the discount rates we estimate to represent our cost of funds. It is possible, however, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of goodwill, we could incur impairment charges.

Warranty. Unless otherwise stated, we provide a one to three year warranty from the original invoice date on all products, materials and workmanship. Defective products are either repaired or replaced, at our option, upon meeting certain criteria. We accrue 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. Should our actual experience of warranty returns be higher than anticipated, additional warranty reserves may be required, which may adversely affect our operating results.

Taxes. We recorded a valuation allowance to reduce our deferred tax assets to amounts that we believe are more likely than not to be realized. Realization of deferred tax assets (such as net operating loss carryforwards) is dependent on future taxable earnings and is therefore uncertain. On a quarterly basis, we assess the likelihood that our deferred tax asset balance will be recovered from future taxable income. To the extent we believe that recovery is not likely, we establish a valuation allowance against our deferred tax asset, increasing our income tax expense in the period such determination is made.

On an interim basis, we estimate what our anticipated annual effective tax rate will be and record a quarterly income tax provision in accordance with this anticipated rate. As the fiscal year progresses, we refine our estimates based upon actual events and earnings during the year. This estimation process can result in significant changes to our expected effective tax rate. When this occurs, we adjust the income tax provision during the quarter in which the change in estimate occurs so that the year-to-date provision reflects the expected annual rate. The changes described in the preceding sentence and the recording of valuation allowances may create fluctuations in our overall effective tax rate from quarter to quarter.

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. The following table should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations.

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
Net sales and contract revenues:				
Net sales	**59.7%**	64.7%	**61.6%**	63.4%
Contract revenues	**40.3**	35.3	**38.4**	36.6
Total net sales and contract revenues	**100.0**	100.0	**100.0**	100.0
Costs and expenses:				
Cost of net sales	**32.0**	34.1	**32.1**	34.0
Cost of contract revenues	**26.8**	22.8	**24.7**	23.9
Gross profit	**41.2**	43.1	**43.2**	42.1
Operating expenses:				
Selling, general and administrative	**29.2**	34.2	**30.3**	30.9
Research and development	**9.5**	9.0	**11.3**	7.8
Stock-based compensation	**0.8**	98.1	**1.7**	32.9
Disposal of fixed assets	—	3.6	—	1.2
Acquired in-process research and development	—	0.2	—	0.4
Deferred compensation plan	**(0.7)**	—	**(0.0)**	—
Amortization of intangible assets	**0.3**	0.4	**0.3**	0.2
Total operating expenses	**39.1**	145.4	**43.5**	73.5
Operating income (loss)	**2.1**	(102.4)	**(0.3)**	(31.4)
Non-operating income (expense):				
Other income (expense), net	**(0.0)**	0.5	**0.0**	3.0
Interest expense, net	**(3.1)**	(2.5)	**(2.9)**	(2.4)
Loss before income taxes and minority interest	**(1.0)**	(104.4)	**(3.2)**	(30.8)
Income tax (expense) benefit	**2.1**	0.4	**1.2**	(0.1)
Minority interest in earnings of subsidiary	—	(0.4)	—	(1.4)
Net income (loss)	**1.1%**	(104.4)%	**(2.0)%**	(32.3)%

Analysis of Quarterly Results of Operations

Net Sales and Contract Revenues. Net sales consist principally of sales of our Vantage video detection systems and AutoVue LDW systems, as well as technology access fees, contract engineering revenue and royalty revenue generated from AutoVue related activities. Contract revenue consists principally of revenue derived from systems integration and ITS consulting services with federal, state, county and municipal agencies. We currently have a diverse customer base with our largest customer constituting 11.2% of total net sales and contract revenues in the three months ended December 31, 2005 and 11.8% of total net sales and contract revenues in the nine months ended December 31, 2005.

Total net sales and contract revenues increased 4.0% and 5.9% to $12.2 million and $37.0 million for the three and nine months ended December 31, 2005, respectively, compared to $11.7 million and $34.9 million in the corresponding periods in the prior fiscal year. These increases were the net result of increased contract revenues and increased net sales of our AutoVue products and services offset by decreased net sales of our Vantage products, as discussed below.

Net sales decreased 4.0% to $7.3 million for the three months ended December 31, 2005 as compared to the corresponding period of the prior fiscal year and increased 2.9% to $22.8 million for the nine months ended December 31, 2005 compared to $22.1 million in the corresponding period in the prior fiscal year. The three and nine month periods both reflect increased unit sales of our AutoVue LDW systems. Net sales from AutoVue products increased 19.6% and 59.8% in the three and nine month periods ended December 31, 2005, respectively, compared to the corresponding periods in the prior year. The increase in sales of AutoVue products was principally related to increased unit sales of LDW systems in the European and North American commercial heavy truck markets. Overall sales of AutoVue products and services, which also include technology access fees, contract engineering revenue and royalty revenue, increased 6.0% in the current quarter to $2.0 million and 22.2% to $6.4 million for the nine month period compared to $1.9 million and $5.2 million in the corresponding periods in the prior fiscal year.

The increased sales of our AutoVue products and services were offset by a 7.4% and 3.1% decrease in Vantage video detection systems sales in the three and nine month periods ended December 31, 2005, respectively, compared to the corresponding periods in the prior fiscal year. In unit terms, Vantage sales growth continues to increase primarily due to increased market adoption of video-based detection technologies for traffic intersection management and our ability to obtain additional contracts with state departments of transportation. The effects of increased unit shipments of Vantage products was more than offset by decreased average selling prices due to the changeover to new lower priced units, an underperforming dealer in the California market and delays in several significant projects. We expect Vantage sales to be relatively flat in unit terms for the quarter ending March 31, 2005 as compared to the quarter ended December 31, 2005 due to the impact of winter weather conditions in many of our markets. The majority of Vantage sales are generated in North America.

Contract revenues increased 18.6% to $4.9 million for the three months ended December 31, 2005 as compared to the corresponding period of the prior fiscal year and increased 11.1% to $14.2 million for the nine months ended December 31, 2005 compared to $12.8 million in the corresponding period in the prior fiscal year. The increase in contract revenues was primarily fueled by increased activity in the California market. Contract revenues reflect a broad range of fixed price and cost plus fixed fee contracts for engineering study and design, systems integration and system implementation. Contract revenues are dependent upon the continued availability of funding on both the state and federal levels from the various departments of transportation. All of our contract revenue is currently derived from work performed in North America.

Gross Profit. Total gross profit was flat at $5.0 million for the three months ended December 31, 2005 and increased 8.7% to $16.0 million for the nine months ended December 31, 2005 compared to $14.7 million in the corresponding period of the prior fiscal year. Total gross profit as a percent of net sales and contract revenues decreased to 41.2% for the three months ended December 31, 2005 as compared to 43.1% for the three months ended December 31, 2004 and increased to 43.2% for the nine months ended December 31, 2005 as compared to 42.1% in the corresponding period of the prior fiscal year.

Gross profit as a percentage of net sales was 46.5% for the three months ended December 31, 2005 compared to 47.2% in the corresponding period of the prior fiscal year and 47.9% for the nine months ended December 31, 2005 compared to 46.3% in the corresponding period of the prior fiscal year. For the three month period ended December 31, 2005, gross profit as a percentage of sales declined from the same period in the prior fiscal year primarily due to increased sales of sample AutoVue LDW units in the prior year. We typically sell such sample units at a much higher price point and achieve a higher gross profit. Both the three and nine month periods ended December 31, 2005 benefited from increased margins related to the Vantage business as a result of lower material and sustaining engineering costs on newer product offerings.

Gross profit as a percentage of contract revenues decreased to 33.4% for the three months ended December 31, 2005 compared to 35.5% in the corresponding period of the prior fiscal year and increased to 35.7% for the nine months ended December 31, 2005 compared to 34.7% in the corresponding period of the prior fiscal year. The decrease in gross profit as a percentage of contract revenues in the three month period ended December 31, 2005 was primarily due to increased payroll costs. For the nine month period ended December 31, 2005, the increase in gross profit as a percentage of contract revenues reflects a mix of higher margin contracts in the period as compared to the corresponding period of the prior fiscal year.

Selling, General and Administrative Expense. Selling, general and administrative expense decreased 11.2% to $3.6 million (or 29.2% of total net sales and contract revenues) in the three months ended December 31, 2005 compared to $4.0 million (or 34.2% of total net sales and contract revenues) in the corresponding period of the prior fiscal year, and increased 3.6% to $11.2 million (or 30.3% of total net sales and contract revenues) in the nine months ended December 31, 2005 compared to $10.8 million (or 30.9% of total net sales and contract revenues) in the corresponding period of the prior fiscal year.

The decrease in selling, general and administrative expenses for the three month period ended December 31, 2005 as compared to the three month period ended December 31, 2004 was primarily due to a higher level of costs incurred in the prior year in connection with the merger of the Iteris Subsidiary into us. For the nine month period ended December 31, 2005, selling, general and administrative expenses increased over the prior year largely as a result of increased auditing and accounting fees incurred by the Company as a direct result of the restatement of the our March 31, 2004, financial statements issued in July 2005, as well as additional consulting fees incurred by us related to preparation for Sarbanes-Oxley compliance. Beginning in the most recent fiscal quarter, we have significantly reduced our Sarbanes-Oxley Section 404 implementation efforts after determining that we will not be required to comply with Section 404 until our fiscal year ending March 31, 2007 at the earliest. We will continue to monitor requirements related to Sarbanes-Oxley Section 404 compliance and may determine the need to increase related expenditures again in the near future to reach compliance by the end of our fiscal year ending March 31, 2007.

Research and Development Expense. Research and development expense increased 9.3% to $1.2 million (or 9.5% of total net sales and contract revenues) in the three months ended December 31, 2005 compared to $1.1 million (or 9.0% of total net sales and contract revenues) in the corresponding period of the prior fiscal year and increased 53.6% to $4.2 million (or 11.3% of total net sales and contract revenues) in the nine months ended December 31, 2005 compared to $2.7 million (or 7.8% of total net sales and contract revenues) in the corresponding period of the prior fiscal year.

The increase in research and development expense in the current three and nine month periods reflects increased spending on development of AutoVue and Vantage products. AutoVue product development has primarily related to the development of our next generation LDW unit for the heavy truck market and was largely focused on re-engineering and qualification of a new imager. In October 2005, the next generation LDW unit was approved for production by our largest truck customer and shipments of this new unit began in our third fiscal quarter. Although the AutoVue development team must qualify the new unit for use by each additional heavy truck customer, we believe the time and cost of future qualifications should decrease as additional heavy truck customers adopt this new unit. Vantage product development primarily reflects activities for product line extensions to support new communications platforms and to accommodate new camera designs.

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

Stock-Based Compensation Expense. On October 22, 2004, as a result of the merger with our Iteris Subsidiary, we recorded an $11.3 million non-cash charge for stock-based compensation in connection with the assumption and exchange of vested Iteris Subsidiary stock options for stock options immediately exercisable for our common stock. This charge was based on the difference between the fair market value of our common stock on the October 22, 2004 merger date and the exercise price of the modified stock options. At the time of the merger, we also recorded $1.4 million in deferred compensation expense related to the unvested Iteris Subsidiary stock options assumed by us. This amount is being amortized to stock-based compensation expense as the options vest. Non-cash charges of $103,000 and $626,000 were recorded for the three and nine month periods ended December 31, 2005, respectively, and non-cash charges of $221,000 were recorded for the three and nine month periods ended December 31, 2004, based on the vesting of these assumed unvested options. The remaining deferred stock-based compensation balance of $194,000 at December 31, 2005 will be amortized over our next three fiscal quarters.

Deferred Compensation Plan Expense. During the three and nine month periods ended December 31, 2005, we recorded non-cash benefits of $90,000 and $12,000, respectively, related to the depreciation in value of 310,510 shares of our common stock held in trust by our deferred compensation savings plan. No changes in value were recorded in the corresponding periods of the prior fiscal year.

Other Income (Expense), Net. Other income, net reflects the following:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
	(In thousands)			
Gain on settlement of lawsuit	**$ —**	$ —	**$ —**	$ 949
Other	**(6)**	60	**32**	91
Other income (expense), net	**$ (6)**	$ 60	**$ 32**	$ 1,040

Other income (expense), net for the nine months ended December 31, 2004 primarily reflects a $949,000 gain recognized on the settlement of litigation between Rockwell International and the Michigan Department of Transportation in which we were a third party beneficiary.

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2005	2004	**2005**	2004
	(in thousands)			
Interest expense	**$ (292)**	$ (205)	**$ (829)**	$ (623)
Amortization of deferred finance costs	**(34)**	(39)	**(103)**	(83)
Amortization of debt discount	**(51)**	(54)	**(155)**	(132)
Interest expense, net	**$ (377)**	$ (298)	**$ (1,087)**	$ (838)

Interest expense increased 26.5% for the three month period ended December 31, 2005 compared to the corresponding period in the prior fiscal year as a result of a higher level of borrowings on our line of credit in the current year. Interest expense increased 29.7% for the nine months ended December 31, 2005 compared to the corresponding period in the prior fiscal year. This increase was largely due to additional interest expense incurred related to the $5.0 million term debt entered into by the Iteris Subsidiary on May 28, 2004 (which we assumed in October 2004), interest expense related to the $10.1 million convertible debentures issued by us on May 19, 2004, and the amortization of debt discounts and deferred financing costs associated with the issuance of the convertible debentures and related warrants.

Income Taxes. During the three and nine month periods ended December 31, 2005, we recognized an income tax benefit of $256,000 and $431,000, respectively, as compared to an income tax benefit of $51,000 in the three month period ended December 31, 2004, and income tax expense of $24,000 for the nine month period ended December 31, 2004. The tax benefit recorded in the three and nine month periods ended December 31, 2005 primarily reflects a reduction in the valuation allowance recorded against our deferred tax assets as a result of changes in estimates of the future realizability of these assets. As a result, total deferred tax assets on our consolidated balance sheet increased from $660,000 at March 31, 2005 to $1.1 million at December 31, 2005. In the future, we may continue to record similar adjustments to our deferred tax asset valuation allowance as our estimates are updated. We anticipate this will likely cause our future effective tax rate in any given period to fluctuate significantly from prior effective tax rates, estimated effective tax rates and statutory tax rates.

Minority Interest in Earnings of Subsidiary. Minority interest in earnings of subsidiary represents the minority stockholders' share of the Iteris Subsidiary's net income or loss combined with the accretion of the redemption preference of the Iteris Subsidiary's Series A preferred stock. The elimination of minority interest in the three and nine month periods ended December 31, 2005 from $52,000 and $485,000 in the three and nine month periods ended December 31, 2004, respectively, was the result of the merger of the Iteris Subsidiary into us on October 22, 2004.

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 equity securities. We currently rely on cash flows from operations and borrowings on a line of credit facility to fund our operations, which we believe to be sufficient to fund our operations for at least the next twelve months. However, should a shortfall occur, we believe we could obtain additional funds through additional borrowings or the sale of equity securities. At December 31, 2005, we had $3.3 million in working capital, which included borrowings of $1.4 million on our revolving line of credit and no cash. This compares to working capital of $2.2 million, $46,000 in cash and an outstanding revolving line of credit balance of $945,000 at March 31, 2005. Our operations provided $941,000 of cash during the nine month period ended December 31, 2005, primarily as a result of planned decreases in inventory to a level more in line with target inventory levels, partially offset by a net decrease in accounts payable and accrued expenses and an increase in net costs and estimated earnings in excess of billings on uncompleted contracts. During the nine months ended December 31, 2004, our operations provided $811,000 of cash, primarily due to the receipt of $949,000 related to a legal settlement between Rockwell International and the Michigan Department of Transportation to which we were a third party beneficiary.

Our investing activities for the nine month periods ended December 31, 2005 and 2004 consisted primarily of purchases of property and equipment, which aggregated $716,000 and $425,000, respectively. In the current fiscal year, capital expenditures have increased significantly primarily due to hardware, software and related labor costs to implement a new enterprise resource management system, which is expected to be put into use at the beginning of our next fiscal year. We expect to continue to invest heavily in this new system over the next three to six months.

Cash used in financing activities was $271,000 in the nine month period ended December 31, 2005, which was the result of net payments against borrowings of $536,000 offset by cash inflows of $265,000 from the exercise of outstanding stock options and warrants to purchase our common stock. During the nine month period ended December 31, 2004, financing activities used $3.0 million of cash, which was comprised of net cash outflows of approximately $3.1 million related to the merger activities described more fully above under the caption "Merger with Iteris Subsidiary" and in Note 3 to the accompanying condensed consolidated financial statements, partially offset by net payments against borrowings of $364,000 and $494,000 in proceeds from the exercise of stock options and warrants to purchase our common stock.

Borrowings

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

	At December 31, 2005 (In thousands)
Convertible debentures, net	$ 9,151
Bank term note	3,021
Promissory note to landlord	1,292
4% note payable	34
Revolving line of credit	1,389
	$ 14,887

Effective August 1, 2005, we renewed our credit agreement with our bank. This credit agreement, which expires on July 31, 2006, provides for borrowings of up to $5.0 million subject to a borrowing formula based upon qualified accounts receivable and inventories as defined in the credit agreement. At December 31, 2005, we had $3.3 million available under the revolving line of credit, of which $1.9 million was unused. We believe the combination of available borrowings on our line of credit and our internally generated cash flows will be sufficient to enable us to execute our operating plans and meet our obligations on a timely basis for at least the next twelve months.

Contractual Obligations

Our contractual obligations are as follows at December 31, 2005:

	Payments Due by Period						
	2006	2007	2008	2009 (In thousands)	2010	Thereafter	Total
Lines of credit	$ 1,389	$ —	$ —	$ —	$ —	$ —	$ 1,389
Notes payable	324	1,918	1,896	208	—	—	4,346
Convertible debentures	—	—	—	—	9,850	—	9,850
Operating leases	349	1,288	792	103	85	43	2,660
Total	$ 2,062	$ 3,206	$ 2,688	$ 311	$ 9,935	$ 43	$ 18,245

Recent Accounting Pronouncements

In November 2004, the FASB issued SFAS 151, which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. SFAS 151 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe the adoption of SFAS 151 will have a material impact on our financial statements.

On December 16, 2004, the FASB issued SFAS 123R, which replaces SFAS 123, supersedes APB 25, and amends SFAS 95. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values (i.e., pro forma disclosure is no longer an alternative to financial statement recognition). In accordance with SEC Release No. 33-8568, SFAS 123R will be effective for us beginning April 1, 2006. We are currently assessing the impact of SFAS 123R. As of the date of this filing, we have not yet concluded as to whether we will apply the modified prospective or retrospective transition method of application; therefore, the effect of adoption cannot be determined at this time.

In May 2005, the FASB issued SFAS 154, which requires retroactive application of a voluntary change in accounting principle to prior period financial statements unless it is impracticable. SFAS 154 also requires that a change in method of depreciation, amortization, or depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is affected by a change in accounting principle. SFAS 154 replaces APB 20 and SFAS 3. We are required to adopt the provisions of SFAS 154 in our fiscal year ending March 31, 2007, and are presently evaluating what effect the adoption of the provisions of SFAS 154 will have on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk is limited to our line of credit. Our line of credit bears interest based on the prevailing prime rate (7.25% at December 31, 2005). A 10% increase in the interest rate on our line of credit (from 10.25% to 11.28%) would not 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 approximates fair value.

ITEM 4. CONTROLS AND PROCEDURES

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting and concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective in timely alerting them to the material information involving transactions occurring in the normal course of business relating to us required to be included in the reports we file or submit under the Securities Exchange Act of 1934, as amended. We did, however, conclude that as of March 31, 2004, we had a material weakness related to the administration and proper accounting for certain types of contracts and agreements.

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. The material weakness described above resulted in improper accounting treatment for the Iteris Subsidiary’s Deferred Compensation Savings Plan and the restatement of our audited consolidated financial statements for the year ended March 31, 2004, with respect to deferred compensation expense and compensation savings plan liabilities.

Management has responded to the above identified material weakness by performing additional accounting, financial analysis and managerial review of procedures in order to ensure that the financial information contained in our quarterly report on Form 10-Q is reliable. In January 2005, we hired a controller to supplement our accounting and finance department. In addition, we hold regular disclosure committee meetings to improve communication regarding the Company’s operations including contract administration. During the most recent completed 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 Note 5 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 our other filings with the SEC. 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 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.

We Have Experienced Substantial Losses And May Continue To Experience Losses For The Foreseeable Future. We experienced net losses from continuing operations of $11.3 million, $1.9 million and $5.3 million in the years ended March 31, 2005, 2004 and 2003, respectively. While we have divested all of our other business units and merged with our Iteris Subsidiary, we cannot assure you that our efforts to downsize our operations or reduce our operating expenses will improve our financial performance, or that we will be able 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.

We May Need To Raise Additional Capital In The Future, Which May Not Be Available On Terms Acceptable To Us, Or At All. We have generated significant net losses and operating losses in recent periods, and have experienced volatility in our cash flows from operations ranging from positive cash flows from operations of $858,000 in the year ended March 31, 2005, to negative cash flows from operations of $718,000 and $4.8 million in the years ended March 31, 2004 and 2003, respectively. Additionally, we failed to meet certain debt covenants under our credit agreement with our bank in two of our last four fiscal quarters. While we completed a $10.1 million convertible debenture financing and our Iteris Subsidiary closed a $5.0 million term loan in May 2004, the majority of the proceeds from such financings were used to purchase the Series A preferred stock of our Iteris Subsidiary held by outside investors.

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 generate net income;
- increased research and development expenses;
- increased sales and marketing expenses;
- technological advancements and our competitors' response to our products;
- 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;
- our ability to successfully negotiate credit arrangements with our bank; 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.

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. Along with our independent registered public accounting firm, we will be evaluating the effectiveness of our internal controls over financial reporting to comply with Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 currently requires us to evaluate the effectiveness of our internal controls over financial reporting at the end of each fiscal year beginning in our next fiscal year ending March 31, 2007 at the earliest, and to include a management report assessing the effectiveness of our internal controls over financial reporting in all annual reports beginning with our Annual Report on Form 10-K for the fiscal year ending March 31, 2007 at the earliest. Section 404 also requires our independent accountant to attest to, and report on, management's assessment of our internal controls over financial reporting. We may not be able to complete our Section 404 compliance on a timely basis and even if we timely complete our compliance 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 error 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 the company 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. 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. Based on our evaluation, our management has concluded that, as of March 31, 2004, our internal control over financial reporting was not effective due to the existence of one material weakness. We may experience additional material weaknesses in the future. 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 Experience Production Gaps Or Delays In the Transition To Our Next Generation LDW System And Have Exhausted Component Supplies For Our Legacy AutoVue LDW Systems, Which Could Materially And Adversely Impact Our Sales And Financial Results And The Ultimate Acceptance Of AutoVue. We are in the process of transitioning to production of a next generation LDW system and have run out of certain components used in the manufacture of our AutoVue LDW units sold to the heavy truck market. Although we have qualified our next generation system with our largest customer, we must continue to qualify the new system with our other customers. As a result, we could experience a gap or delay in production as we transition to this next generation system. In some cases, such gaps or delays may be driven by customer transition issues. Additionally, it is possible that we could experience unforeseen quality control issues as we ramp up to full production of our next generation LDW system. Should any such delay or disruption occur in transitioning to production of our next generation LDW system, our sales will likely be materially and adversely affected.

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 were derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. Government contracts represented approximately 37.4%, 48.2% and 53.8% of our total net sales and contract revenues for the years ended March 31, 2005, 2004 and 2003, respectively. We anticipate that revenue from government contracts will continue to increase in the near future. 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;
- performance bond requirements;
- changes in government policies and political agendas;
- delays in funding, including the delays in the allocation of funds to state and local agencies from the U.S. transportation bill;
- other government budgetary constraints and cut-backs; and
- 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 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 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. If Valeo does not devote considerable resources and aggressively pursue opportunities, our expansion into the passenger car market could be adversely affected.

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. Our future success will also depend in part on the success of the vehicles or other products which incorporate our AutoVue LDW system.

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. 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. 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 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.

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.

An Economic Slowdown And Related Uncertainties Could Adversely Impact The Demand For Our Products. Concerns about inflation, decreased consumer confidence, reduced corporate profits and capital spending, and recent international conflicts and terrorist and military actions have resulted in a downturn in worldwide economic conditions, particularly in the United States. These unfavorable economic conditions may have a negative impact on customer orders, cancellations and rescheduling of backlog. In addition, recent political and social turmoil related to international conflicts and terrorist acts can be expected to put further pressure on economic conditions in the U.S. and worldwide. These political, social and 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 will likely be materially and adversely affected.

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.

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:

- our ability to raise additional capital;
- our ability to control costs;
- 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;
- the size, timing, rescheduling or cancellation of significant customer orders;
- the introduction of new products by competitors;
- the availability of components used in the manufacture of our products;
- 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;
- delays in the allocation of funds to state and local agencies from the U.S. government transportation bill;
- our success in expanding and implementing our sales and marketing programs;
- the effects of technological changes in our target markets;
- our relatively small level of backlog at any given time;
- seasonality due to winter weather conditions;
- the mix of our sales;
- 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.

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;
- frequent new product introductions and enhancements; 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.

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. 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.

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 any of our 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. Competition for 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.

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.

From time to time, we have received notices that claim we have infringed upon the intellectual property of others. Even if these claims are not valid, they could subject us to significant costs. We have engaged in litigation in the past, and 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.

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 issues;
- 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 recently experienced volatility, which has particularly 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.

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;
- reduced protection for intellectual property rights in some countries;
- 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;

- longer accounts receivable payment cycles;
- difficulties in managing and staffing international operations;
- potentially adverse tax consequences; and
- import and export license requirements and restrictions of the United States and each other country in which we operate.

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.

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, with the exception of our Iteris business, from time to time we could experience unforeseen developments in contingencies related to our former subsidiaries. In particular, we are presently party to a lawsuit brought against Mariner Networks, Inc., one of our former subsidiaries (refer to Note 5 to the condensed consolidated financial statements). We are also presently undergoing a sales tax audit in the state of California covering periods and transactions related to our former subsidiaries. The outcome of this lawsuit and sales tax audit are presently uncertain. Although we are not aware of any other material contingencies, it is possible that 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, 2005, our officers and directors owned approximately 16% of the outstanding shares of our common stock (and approximately 25% 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, 2005). As a result of their stock ownership, our management will be able to significantly 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 Anti-Takeover Provisions May Affect The Price Of Our Common Stock And Discourage A Third Party From Acquiring Us. Certain provisions of our certificate of incorporation and our stockholder rights plan 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 could be used to discourage an unsolicited acquisition proposal. In addition, in March 1998, we adopted a stockholder rights plan and declared a dividend of preferred stock purchase rights to our stockholders. We amended this plan in May 2004. In the event a third party acquires more than 15% of the outstanding voting control of our company or 15% of our outstanding common stock, the holders of these rights will be able to purchase the junior participating preferred stock at a substantial discount off of the then current market price. The exercise of these rights and purchase of a significant amount of stock at below market prices could cause substantial dilution to a particular acquirer and discourage the acquirer from pursuing our company. The mere existence of a stockholder rights plan often delays or makes a merger, tender offer or proxy contest more difficult.

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

None.

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	*Exhibit 3.1 to the registrant's current report on Form 8-K as filed with the SEC on October 28, 2004*
3.2	Bylaws of registrant, as amended	*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*
3.3	Certificates of Amendment to Bylaws of the registrant dated April 24, 1998 and August 10, 2001	*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*
3.4	Certificate of Amendment to Bylaws of registrant dated September 9, 2004	*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*
4.1	Specimen of Common Stock Certificate	*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*
4.2	Amended and Restated Rights Agreement, dated as of May 10, 2004, by and between the registrant and U.S. Stock Transfer Corporation, including exhibits thereto	*Exhibit 99.1 to the registrant's Registration Statement on Form 8-A/A as filed with the SEC on June 18, 2004*
10.1	Second Amendment to Credit Agreement, dated August 1, 2005, by and between the registrant and Wells Fargo Bank, National Association	*Filed herewith*
10.2	Revolving Line of Credit Note, dated August 1, 2005, by and between the registrant and Wells Fargo Bank, National Association	*Filed herewith*
31.1	Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	*Filed herewith*
31.2	Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	*Filed herewith*
32.1	Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	*Filed herewith*
32.2	Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	*Filed herewith*

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 8, 2006

ITERIS, INC.
(Registrant)

By /s/ JACK JOHNSON
Jack Johnson
Chief Executive Officer
(Principal Executive Officer)

By /s/ JAMES S. MIELE
James S. Miele
Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit 10.1

SECOND AMENDMENT TO CREDIT AGREEMENT

THIS SECOND AMENDMENT TO CREDIT AGREEMENT (this "Amendment") is entered into as of August 1, 2005, by and between ITERIS, INC., a Delaware corporation ("Borrower"), and WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank").

RECITALS

A. Borrower is currently indebted to Bank pursuant to the terms and conditions of that certain Credit Agreement dated as of May 27, 2004 (the "Agreement") between Iteris, Inc. ("Original Borrower") and Bank, as amended by that certain Assumption and Amendment Agreement dated October 20, 2004 (the "Assumption Agreement") between Iteris Holdings, Inc. ("Second Original Borrower") and Bank, pursuant to which the Second Original Borrower assumed the obligations of the Original Borrower under the Agreement. The Agreement, together with the Assumption Agreement, each as amended from time to time, is hereinafter collectively referred to as the "Credit Agreement". The Second Original Borrower amended its corporate name to Iteris, Inc. pursuant to that certain amended and restated certificate of incorporation dated October 22, 2004, filed October 22, 2004 with Secretary of State, State of Delaware and as such is the "Borrower" referred to herein and party hereto.

B. Pursuant to the Credit Agreement, Borrower remains indebted to Bank under a line of credit in the maximum principal amount of Five Million Dollars ($5,000,000.00) (the "Prior Line of Credit"), which is evidenced by that certain Revolving Line of Credit Note dated May 27, 2004 (as may have been amended from time to time, the "Prior Line of Credit Note"). The Prior Line of Credit Note matures and becomes due and payable in full on August 1, 2005 and as of the date hereof, the outstanding principal balance under the Prior Line of Credit is $2,451,474.00, plus accrued but unpaid interest.

C. Pursuant to the Credit Agreement, Borrower remains indebted to Bank under a term loan in the original principal amount of Five Million Dollars ($5,000,000.00) (the "Term Loan"), which is evidenced by that certain Term Note dated May 27, 2004 (as may be amended from time to time, the "Term Note"). The Term Note shall mature and become due and payable in full on May 27, 2008 and as of the date hereof, the outstanding principal balance under the Term Loan is $3,541,668.02, plus accrued but unpaid interest.

D. Bank and Borrower have agreed to certain changes in the terms and conditions set forth in the Credit Agreement and have agreed to amend the Credit Agreement to reflect said changes.

NOW, THEREFORE, for valuable consideration, the receipt and sufficiency of which are hereby acknowledged, subject to the terms and conditions described herein, the parties hereto agree that the Credit Agreement shall be amended as follows; provided, however, that nothing shall terminate any security interests, subordinations or other documents in favor of Bank, all of which shall remain in full force and effect unless expressly amended hereby:

1. Amendment to Section 1.1(a). Section 1.1(a) of the Credit Agreement is hereby deleted in its entirety, and the following substituted therefor:

> "(a) Line of Credit. Subject to the terms and conditions of this Agreement, Bank hereby agrees to make advances to Borrower from time to time up to and including July 31, 2006, not to exceed at any time the aggregate principal amount of Five Million Dollars ($5,000,000.00) ("Line of Credit"), the proceeds of which shall be used to pay off the outstanding principal balance of the Prior Line of Credit and for Borrower's working capital requirements. Borrower's obligation to repay advances under the Line of Credit shall be evidenced by a promissory note dated as of August 1, 2005 ("Line of Credit Note"), all terms of which are incorporated herein by this reference."

2. Amendment to Section 1.1(b). The first sentence of Section 1.1(b) of the Credit Agreement is hereby deleted in its entirety, and the following substituted therefor:

> "(b) Limitation on Borrowings. Outstanding borrowings under the Line of Credit, to a maximum of the principal amount set forth above, shall not at any time exceed an aggregate of (i) eighty percent (80%) of Borrower's eligible accounts receivable (Non-Government/Non-Consulting), (ii) forty percent (40%) of Borrower's eligible accounts receivable (Government/Consulting), provided that outstanding borrowings against such accounts receivable shall not exceed Seven Hundred Fifty Thousand and 00/100 Dollars ($750,000.00), and (iii) fifty percent (50%) of the value of Borrower's eligible inventory, (exclusive of work in process and inventory which is obsolete, unsaleable or damaged), with value defined as the lower cost or market value, provided however, that outstanding borrowings against inventory shall not at any time exceed an aggregate of One Million and 00/100 Dollars ($1,000,000.00), plus $1,500,000.00. Notwithstanding any other provision of this Agreement, the aggregate amount of all outstanding borrowings hereunder shall not at any time exceed the lesser of: (i) maximum amount of the Line of Credit plus the outstanding principal balance of the Term Loan; or (ii) the maximum borrowing base amount as set forth above. If either of the above amounts are exceeded, the Line of Credit shall be considered overadvanced by any such excess amount, and the Borrower shall immediately repay such excess amount. Failure to immediately repay such excess amounts shall constitute an Event of Default under Section 6.1(a) hereof.

3. Amendment to Section 1.5. The following is hereby added to the Credit Agreement as a new Section 1.5:

> "SECTION 1.5 COLLECTION OF PAYMENTS. Borrower authorizes Bank to collect all principal, interest and fees due under each credit subject hereto by charging Borrower's deposit account number 4173283292 with Bank, or any other deposit account maintained by Borrower with Bank, for the full amount thereof. Should there be insufficient funds in any such deposit account to pay all such sums when due, the full amount of such deficiency shall be immediately due and payable by Borrower."

4. Amendment to Section 2.5. Section 2.5 of the Credit Agreement is hereby amended by deleting "March 31, 2004" as the date of Borrower's most current financial statement delivered to Bank, and by substituting "June 30, 2005" for said date.

5. Amendment to Section 4.3. Section 4.3 of the Credit Agreement is hereby deleted in its entirety, and the following substituted therefor:

"SECTION 4.3. FINANCIAL STATEMENTS. Provide to Bank all of the following, in form and detail satisfactory to Bank:

(a) not later than 120 days after and as of the end of each fiscal year, an audited financial statement of Borrower, prepared by a certified public accountant acceptable to Bank, to include balance sheet, statement of income and statement of cash flows; and within 120 days after filing, but in no event later than each October 31, copies of Borrower's filed federal income tax returns for such year;

(b) not later than 45 days after and as of the end of each fiscal quarter, a financial statement of Borrower, prepared by Borrower, to include balance sheet, statement of income and statement of cash flows;

(c) not later than 15 days after and as of the end of each month, a borrowing base certificate, an inventory collateral report, an aged listing of accounts receivable and accounts payable, and a reconciliation of accounts, and not later than each June 30 and December 31, a list of the names, addresses and phone numbers of all Borrower's account debtors;

(d) from time to time such other information as Bank may reasonably request ."

6. Amendment to Section 4.9. Section 4.9 of the Credit Agreement is hereby deleted in its entirety, and the following substituted therefor:

"SECTION 4.9 FINANCIAL CONDITION. Maintain Borrower's financial condition as follows using generally accepted accounting principles consistently applied and used consistently with prior practices (except to the extent modified by the definitions herein), with compliance determined commencing with Borrower's financial statements for the period ending December 31, 2005:

(a) Senior Funded Debt to EBITDA not greater than 6.75 to 1.0 at December 31, 2005; not greater than 4.10 to 1.0 at March 31, 2006 and thereafter, with "Senior Funded Debt" defined as the sum of all obligations for borrowed money plus all capital lease obligations less subordinated debt, and with "EBITDA" defined as net profit before taxes, plus interest expense plus amortization of intangibles plus depreciation, plus deferred finance expense amortization, plus debt discount amortization, plus deferred gain on sale of property, plus amortization of non-cash stock based compensation expense, each to be measured on a year-to-date, annualized basis.

(b) Fixed Charge Coverage Ratio not less than .65 to 1.0 for quarter ending December 31, 2005; not less than 1.25 to 1.0 for quarter ending March 31, 2006, and quarterly thereafter. "Fixed Charge Coverage Ratio" shall mean consolidated EBITDA minus non-financed capital expenditures divided by the aggregate sum of (i) all interest paid or payable on the Funded Debt, (ii) all installment of scheduled principal during the period, (iii) all income taxes paid or payable, plus (iv) the amount of dividends declared or paid in cash, and "EBITDA" has the meaning to it given above. "Funded Debt" shall mean the sum of obligations for borrowed money plus all capital lease obligations."

7. The following is hereby added to the Credit Agreement as Section 4.11:

"SECTION 4.11. CREDITORS' FORMATION DOCUMENTS. On or before December 31, 2005, Borrower shall deliver to Bank copies of the filed formation documents for each of the business entities or the trust entities identified as Subordinated Creditors on the Acknowledgment and Consent of Subordinated Creditors attached to the Second Amendment to Credit Agreement dated as of August 1, 2005 between Borrower and Bank."

8. Amendment to Section 7.2. Section 7.2 of the Credit Agreement is hereby amended by deleting the existing address for Bank and replacing such address with the following: "Los Angeles Office, 333 South Grand Avenue, 9th Floor, Los Angeles, CA 90071."

9. Restructuring Fee. In consideration of the changes set forth herein and as a condition to the effectiveness hereof, immediately upon signing this Amendment Borrower shall pay to Bank a non-refundable fee of $50,000.00 (the "Restructuring Fee").

10. Conditions Precedent. The obligation of Bank to amend the terms and conditions of the Credit Agreement as provided herein, is subject to the fulfillment to Bank's satisfaction of all of the following conditions by no later than November 28, 2005:

(a) Bank shall have received, in form and substance satisfactory to Bank, each of the following, duly executed:

(i) This Amendment.
(ii) The Line of Credit Note.
(iii) Subordination Agreements (9).
(iv) Partnership, Joint Venture or Association Certificate: Subordination (3).
(v) Acknowledgment and Consent of Subordinated Creditors attached hereto.
(vi) Such other documents as Bank may require under any other section of this Amendment.

(b) Restructuring Fee. Bank shall have received the Restructuring Fee in immediately available funds.

(c) Other Fees and Costs. In addition to Borrower's obligations under the Credit Agreement and the other Loan Documents, Borrower shall have paid to Bank the full amount of all costs and expenses, including reasonable attorneys' fees (including the allocated costs of

Bank's in-house counsel) expended or incurred by Bank in connection with the negotiation and preparation of this Amendment, for which Bank has made demand.

(d) Subordinated Note. Bank shall have received the original Secured Promissory Note dated July 1, 2003, in the amount of $811,347.00 between Odetics, Inc., 1515 South Manchester, LLC, Dartbrook-Twin Oaks, L.P., and William T. White, III, LLC and the original First Amendment to Secured Promissory Note dated November 1, 2004 between Iteris, Inc., 1515 South Manchester, LLC, Dartbrook-Twin Oaks, L.P., and William T. White, III, LLC, each notated with a legend satisfactory to Bank to the effect that the holders of each such note are bound by the terms of a subordination agreement in favor of the Bank.

(e) Interest. Interest under the Prior Line of Credit Note shall have been paid current.

(f) Interest and Principal. Interest and principal under the Term Note shall have been paid current.

11. General Release. In consideration of the benefits provided to Borrower under the terms and provisions hereof, Borrower hereby agrees as follows ("General Release"):

(a) Borrower, for itself and on behalf of its successors and assigns, does hereby release, acquit and forever discharge Bank, all of Bank's predecessors in interest, and all of Bank's past and present officers, directors, attorneys, affiliates, employees and agents, of and from any and all claims, demands, obligations, liabilities, indebtedness, breaches of contract, breaches of duty or of any relationship, acts, omissions, misfeasance, malfeasance, causes of action, defenses, offsets, debts, sums of money, accounts, compensation, contracts, controversies, promises, damages, costs, losses and expenses, of every type, kind, nature, description or character, whether known or unknown, suspected or unsuspected, liquidated or unliquidated, each as though fully set forth herein at length (each, a "Released Claim" and collectively, the "Released Claims"), that Borrower now has or may acquire as of the later of: (i) the date this Amendment becomes effective through the satisfaction (or waiver by Bank) of all conditions hereto; or (ii) the date that Borrower has executed and delivered this Amendment to Bank (hereafter, the "Release Date"), including without limitation, those Released Claims in any way arising out of, connected with or related to any and all prior credit accommodations, if any, provided by Bank, or any of Bank's predecessors in interest, to Borrower, and any agreements, notes or documents of any kind related thereto or the transactions contemplated thereby or hereby, or any other agreement or document referred to herein or therein.

(b) Borrower hereby acknowledges, represents and warrants to Bank as follows:

(i) Borrower understands the meaning and effect of Section 1542 of the California Civil Code, which provides:

"Section 1542. GENERAL RELEASE; EXTENT. A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM MUST HAVE MATERIALLY AFFECTED HIS SETTLEMENT WITH THE DEBTOR."

(ii) With regard to Section 1542 of the California Civil Code, Borrower agrees to assume the risk of any and all unknown, unanticipated or misunderstood defenses and

Released Claims which are released by the provisions of this General Release in favor of Bank, and Borrower hereby waives and releases all rights and benefits which it might otherwise have under Section 1542 of the California Civil Code with regard to the release of such unknown, unanticipated or misunderstood defenses and Released Claims.

(c) Each person signing below on behalf of Borrower acknowledges that he or she has read each of the provisions of this General Release. Each such person fully understands that this General Release has important legal consequences and each such person realizes that they are releasing any and all Released Claims that Borrower may have as of the Release Date. Borrower hereby acknowledges that it has had an opportunity to obtain a lawyer's advice concerning the legal consequences of each of the provisions of this General Release.

(d) Borrower hereby specifically acknowledges and agrees that: (i) none of the provisions of this General Release shall be construed as or constitute an admission of any liability on the part of Bank; (ii) the provisions of this General Release shall constitute an absolute bar to any Released Claim of any kind, whether any such Released Claim is based on contract, tort, warranty, mistake or any other theory, whether legal, statutory or equitable; and (iii) any attempt to assert a Released Claim barred by the provisions of this General Release shall subject Borrower to the provisions of applicable law setting forth the remedies for the bringing of groundless, frivolous or baseless claims or causes of action.

12. Miscellaneous. Except as specifically provided herein, all terms and conditions of the Credit Agreement shall remain in full force and effect, without waiver or modification. All terms defined in the Credit Agreement shall have the same meaning when used in this Amendment. This Amendment and the Credit Agreement shall be read together, as one document. This Amendment may be executed in any number of counterparts, each of which when executed and delivered shall be deemed to be an original, and all of which when taken together shall constitute one and the same Amendment.

13. Reaffirmation; Certification. Borrower hereby remakes all representations and warranties contained in the Credit Agreement and reaffirms all covenants set forth therein. Borrower further certifies that as of the date of this Amendment there exists no Event of Default as defined in the Credit Agreement, nor any condition, act or event which with the giving of notice or the passage of time or both would constitute an Event of Default. Borrower reaffirms and ratifies all Loan Documents executed by it or its predecessors prior to the date hereof.

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be executed as of the day and year first written above.

ITERIS, INC.	WELLS FARGO BANK, NATIONAL ASSOCIATION
By: ______________________	By: ______________________ Darryl Hallie, Vice President/Principal
Title: ______________________	
By: ______________________	
Title: ______________________	

ACKNOWLEDGMENT AND CONSENT OF SUBORDINATED CREDITORS

The undersigned, Subordinated Creditors of Borrower, acknowledge and agree they have read the foregoing Amendment and that their respective Subordination Agreements heretofore executed by them, Borrower and Bank, shall continue in full force and effect (notwithstanding the lack of acknowledgment, if any, to any prior amendments to any of the Loan Documents between Borrower and bank), and that any indebtedness of Borrower to such Subordinated Creditor and the security interests, if any, granted to secure such debt remain junior and subordinated to (i) all indebtedness of Borrower to Bank, including without limitation, indebtedness evidenced by the foregoing Amendment and (ii) any security interests granted to Bank to secure such indebtedness.

SUBORDINATED CREDITORS:

1515 South Manchester, LLC

By: ______________________________

Title: ____________________________

Dartbrook-Twin Oaks, L.P.

By: 1515 South Manchester, LLC,
its attorney-in-fact

By: ______________________________

Title: ____________________________

William T. White, III, LLC
By: 1515 South Manchester, LLC,
its attorney-in-fact

By: ______________________________

Title: ____________________________

____
Lloyd I. Miller

____
Lloyd I. Miller, III

____
Susan Riley

____
Abby Riley, aka Abigail Riley

____
Eloise Riley

____
Stephen Edwin Rowe, aka
Stephen E. Rowe

____
Irv Kessler, aka Irvin R. Kessler

____
Abbas Mohaddes

____
Charlie Riley

____
Tom Kelleher

Milfam II L.P.

By: Milfam LLC, General Partner

By: ______________________

Title: ______________________

Milfam I L.P.

By: Milfam LLC, General Partner

By: ______________________

Title: ______________________

Provident Premier Master Fund Ltd.

By: ______________________

Title: ______________________

Bainbridge Partners, LLC

By: ______________________
Edward G. Victor
Title: Manager

Potomac Capital International Ltd.

By: ______________________
Paul J. Solit
Title: ______________________

Potomac Capital Partners, LP

By: ______________________
Paul J. Solit
Title: ______________________

Lloyd I. Miller Trust A-4

By: ______________________

Title: ______________________

____
Jon D. Gruber, Trustee of the
Jon D. and Linda W. Gruber Trust

____
Linda W. Gruber, Trustee of the
Jon D. and Linda W. Gruber Trust

Lagunitas Partners, a California Limited Partnership

By: Gruber & McBaine Capital Management
General Partner

By: ______________________
Eric B. Swergold
Title: ______________________

Gruber & McBaine International

By: ______________________
Eric B. Swergold
Title: ______________________

Charles Schwab, Inc., Custodian for Francis Memole IRA

By: ______________________________

Title: ______________________________

Wachovia Securities Custodian for Greg Miner IRA

By: ______________________________

Title: ______________________________

Charles Schwab, Inc., Custodian for John Johnson IRA

By: ______________________________

Title: ______________________________

Exhibit 10.2

REVOLVING LINE OF CREDIT NOTE

$5,000,000.00 Los Angeles, California
August 1, 2005

FOR VALUE RECEIVED, the undersigned ITERIS, INC. ("Borrower") promises to pay to the order of WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank") at its office at 333 South Grand Avenue, 9th Floor, Los Angeles, California 90071, or at such other place as the holder hereof may designate, in lawful money of the United States of America and in immediately available funds, the principal sum of Five Million Dollars ($5,000,000.00), or so much thereof as may be advanced and be outstanding, with interest thereon, to be computed on each advance from the date of its disbursement as set forth herein.

INTEREST:

(a) Interest. The outstanding principal balance of this Note shall bear interest (computed on the basis of a 360-day year, actual days elapsed) at a rate per annum three percent (3.00%) above the Prime Rate in effect from time to time. The "Prime Rate" is a base rate that Bank from time to time establishes and which serves as the basis upon which effective rates of interest are calculated for those loans making reference thereto. Each change in the rate of interest hereunder shall become effective on the date each Prime Rate change is announced within Bank.

(b) Payment of Interest. Interest accrued on this Note shall be payable on the first day of each month, commencing September 1, 2005.

(c) Default Interest. From and after the maturity date of this Note, or such earlier date as all principal owing hereunder becomes due and payable by acceleration or otherwise, the outstanding principal balance of this Note shall bear interest until paid in full at an increased rate per annum (computed on the basis of a 360-day year, actual days elapsed) equal to four percent (4%) above the rate of interest from time to time applicable to this Note.

BORROWING AND REPAYMENT:

(a) Borrowing and Repayment. Borrower may from time to time during the term of this Note borrow, partially or wholly repay its outstanding borrowings, and reborrow, subject to all of the limitations, terms and conditions of this Note and of any document executed in connection with or governing this Note; provided however, that the total outstanding borrowings under this Note shall not at any time exceed the principal amount stated above. The unpaid principal balance of this obligation at any time shall be the total amounts advanced hereunder by the holder hereof less the amount of principal payments made hereon by or for any Borrower, which balance may be endorsed hereon from time to time by the holder. The outstanding principal balance of this Note shall be due and payable in full on July 31, 2006.

(b) Advances. Advances hereunder, to the total amount of the principal sum stated above, may be made by the holder at the oral or written request of (i) Abbas Mohaddes or James S. Miele, any one acting alone, who are authorized to request advances and direct the disposition of any advances until written notice of the revocation of such authority is received by the holder at the office designated above, or (ii) any person, with respect to advances deposited to the credit of any deposit account of any Borrower, which advances, when so deposited, shall be conclusively presumed to have been made to or for the benefit of each Borrower regardless of the fact that persons other than those authorized to request advances may have authority to draw against such account. The holder shall have no obligation to determine whether any person requesting an advance is or has been authorized by any Borrower.

(c) Application of Payments. Each payment made on this Note shall be credited first, to any interest then due and second, to the outstanding principal balance hereof.

EVENTS OF DEFAULT:

This Note is made pursuant to and is subject to the terms and conditions of that certain Credit Agreement between Borrower and Bank dated as of May 27, 2004, as amended from time to time (the "Credit Agreement"). Any default in the payment or performance of any obligation under this Note, or any defined event of default under the Credit Agreement, shall constitute an "Event of Default" under this Note.

MISCELLANEOUS:

(a) Remedies. Upon the occurrence of any Event of Default, the holder of this Note, at the holder's option, may declare all sums of principal and interest outstanding hereunder to be immediately due and payable without presentment, demand, notice of nonperformance, notice of protest, protest or notice of dishonor, all of which are expressly waived by each Borrower, and the obligation, if any, of the holder to extend any further credit hereunder shall immediately cease and terminate. Each Borrower shall pay to the holder immediately upon demand the full amount of all payments, advances, charges, costs and expenses, including reasonable attorneys' fees (to include outside counsel fees and all allocated costs of the holder's in-house counsel), expended or incurred by the holder in connection with the enforcement of the holder's rights and/or the collection of any amounts which become due to the holder under this Note, and the prosecution or defense of any action in any way related to this Note, including without limitation, any action for declaratory relief, whether incurred at the trial or appellate level, in an arbitration proceeding or otherwise, and including any of the foregoing incurred in connection with any bankruptcy proceeding (including without limitation, any adversary proceeding, contested matter or motion brought by Bank or any other person) relating to any Borrower or any other person or entity.

(b) Obligations Joint and Several. Should more than one person or entity sign this Note as a Borrower, the obligations of each such Borrower shall be joint and several.

(c) Governing Law. This Note shall be governed by and construed in accordance with the laws of the State of California.

This note supersedes and replaces that certain Revolving Line of Credit Note dated May 27, 2004, in the maximum amount of $5,000,000.00, executed by Borrower in favor of Bank.

IN WITNESS WHEREOF, the undersigned has executed this Note as of the date first written above.

ITERIS, INC.

By: ______________________________

Title ______________________________

By: ______________________________

Title ______________________________

EXHIBIT 31.1

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

I, Jack Johnson, 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)) 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 subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) 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

(c) 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 8, 2006

/s/ JACK JOHNSON
Jack Johnson
Chief Executive Officer
(*Principal Executive Officer*)

EXHIBIT 31.2

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)) 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 subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) 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

(c) 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 8, 2006

/s/ JAMES S. MIELE
Chief Financial Officer
(*Principal Financial and Accounting Officer*)

EXHIBIT 32.1

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, 2005 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Jack Johnson, 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/ JACK JOHNSON
Jack Johnson
Chief Executive Officer

February 8, 2006

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.

EXHIBIT 32.2

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, 2005 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 8, 2006

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.