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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**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 September 30, 2006

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 November 10, 2006, the registrant had 30,685,110 shares of common stock outstanding

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

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

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

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. FINANCIAL STATEMENTS**

**ITERIS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except per share amounts)

	September 30, 2006 (unaudited)	March 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 19	\$ 131
Trade accounts receivable, net of allowance for doubtful accounts of \$555 and \$429 at September 30, 2006 and March 31, 2006, respectively	12,462	11,426
Costs and estimated earnings in excess of billings on uncompleted contracts	3,033	2,693
Inventories, net of reserve for inventory obsolescence of \$721 and \$592 at September 30, 2006 and March 31, 2006, respectively	4,792	2,814
Deferred income taxes	761	790
Prepaid expenses and other current assets	504	368
Total current assets	21,571	18,222
Property and equipment, net	1,745	1,783
Deferred income taxes	1,475	818
Intangible assets, net of accumulated amortization of \$334 and \$261 at September 30, 2006 and March 31, 2006, respectively	478	551
Goodwill	27,774	27,774
Other assets	438	485
Total assets	<u>\$ 53,481</u>	<u>\$ 49,633</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Trade accounts payable	\$ 6,161	\$ 3,620
Accrued payroll and related expenses	2,924	3,481
Accrued liabilities	2,749	2,304
Billings in excess of costs and estimated earnings on uncompleted contracts	845	893
Revolving line of credit	577	2,662
Current portion of long-term debt	2,261	1,969
Total current liabilities	15,517	14,929
Non-current accrued liabilities	216	12
Deferred compensation plan liability	788	820
Deferred gain on sale of building	307	449
Long-term debt	1,213	2,171
Convertible debentures, net	9,307	9,203
Total liabilities	27,348	27,584
Commitments and contingencies		
Redeemable common stock, 1,219 shares issued and outstanding at September 30, 2006 and March 31, 2006	3,414	3,414
Stockholders' equity:		
Preferred stock, \$1.00 par value, 2,000 shares authorized, none issued and outstanding at September 30, 2006 and March 31, 2006	—	—
Common stock, \$0.10 par value, 50,000 shares authorized, 29,363 and 27,432 shares issued and outstanding at September 30, 2006 and March 31, 2006, respectively	2,936	2,743
Additional paid-in capital	129,538	126,664
Common stock held in trust, 311 shares at September 30, 2006 and March 31, 2006	(374)	(374)
Notes receivable from employees	(45)	(49)
Accumulated deficit	(109,345)	(110,356)
Accumulated other comprehensive income	9	7
Total stockholders' equity	22,719	18,635
Total liabilities and stockholders' equity	<u>\$ 53,481</u>	<u>\$ 49,633</u>

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 September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Net sales and contract revenues:				
Net sales	\$ 9,323	\$ 7,975	\$ 17,923	\$ 15,500
Contract revenues	5,143	4,740	10,359	9,294
Total net sales and contract revenues	14,466	12,715	28,282	24,794
Costs and expenses:				
Cost of net sales(a)	5,296	4,236	10,054	7,991
Cost of contract revenues(a)	3,213	3,037	6,552	6,006
Gross profit	5,957	5,442	11,676	10,797
Operating expenses:				
Selling, general and administrative(a)	3,985	4,086	7,986	7,914
Research and development(a)	771	1,370	1,774	3,116
Deferred compensation plan	34	16	(32)	78
Amortization of intangible assets	37	36	73	73
Total operating expenses	4,827	5,508	9,801	11,181
Operating income (loss)	1,130	(66)	1,875	(384)
Non-operating income (expense):				
Other income (expense), net	45	86	(645)	38
Interest expense, net	(424)	(358)	(810)	(710)
Income (loss) before income taxes	751	(338)	420	(1,056)
Income tax benefit (provision)	(19)	183	591	175
Net income (loss)	\$ 732	\$ (155)	\$ 1,011	\$ (881)
Earnings (loss) per share:				
Basic	\$ 0.03	\$ (0.01)	\$ 0.04	\$ (0.03)
Diluted	\$ 0.02	\$ (0.01)	\$ 0.03	\$ (0.03)
Weighted average shares outstanding:				
Basic	28,882	28,106	28,637	28,084
Diluted	33,020	28,106	32,694	28,084
(a) Includes stock-based compensation expense as follows:				
Cost of net sales	\$ 4	\$ 9	\$ 9	\$ 18
Cost of contract revenues	\$ 19	\$ 67	\$ 48	\$ 137
Selling, general and administrative expense	\$ 5	\$ 136	\$ 59	\$ 275
Research and development expense	\$ 46	\$ 46	\$ 58	\$ 93

See accompanying notes to unaudited condensed consolidated financial statements.

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

	<b>Six Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities</b>		
Net income (loss)	\$ 1,011	\$ (881)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Change in deferred tax assets	(628)	(189)
Depreciation and amortization of property and equipment	278	335
Stock-based compensation expense	174	523
Issuance of warrants for services	21	—
Amortization of deferred gain on sale—leaseback transaction	(142)	(142)
Amortization of debt discount	104	104
Amortization of intangible assets	73	73
Amortization of deferred financing costs	69	69
Changes in operating assets and liabilities:		
Accounts receivable	(1,036)	(17)
Net costs and estimated earnings in excess of billings	(388)	(435)
Inventories	(1,978)	1,341
Prepaid expenses and other assets	(158)	(177)
Accounts payable and accrued liabilities	2,735	(563)
Net cash provided by operating activities	135	41
<b>Cash flows from investing activities</b>		
Purchases of property and equipment	(240)	(386)
<b>Cash flows from financing activities</b>		
Proceeds (payments) from borrowings on line of credit, net	(2,085)	766
Payments on long-term debt	(666)	(657)
Change in checks drawn in excess of available bank balances	81	—
Proceeds from stock option and warrant exercises	2,663	190
Net cash (used in) provided by financing activities	(7)	299
Decrease in cash	(112)	(46)
Cash at beginning of period	131	46
Cash at end of period	<u>\$ 19</u>	<u>\$ —</u>
<b>Supplemental cash flow information:</b>		
Cash paid during the period:		
Interest	\$ 637	\$ 528
Income taxes	—	44
<b>Supplemental schedule of non-cash investing and financing activities:</b>		
Fair value of common stock issued in settlement of liabilities	\$ 213	\$ —
Fair value of warrants issued in settlement of liabilities	—	28

See accompanying notes to unaudited condensed consolidated financial statements.

**ITERIS, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**

**1. Description of Business and Summary of Significant Accounting Policies**

**Description of Business**

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

**Basis of Presentation**

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

**Use of Estimates**

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

**Revenue Recognition**

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

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

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

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

#### **Concentration of Credit Risk**

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

#### **Fair Values of Financial Instruments**

The fair values of cash and cash equivalents, receivables, inventories, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity. The fair values of line of credit agreements and long-term debt approximate carrying value because the related rates of interest approximate current market rates. The fair value of convertible debentures approximates carrying value because the effective interest rate, taking into account recorded debt discounts, approximates current market rates. The estimated fair value of redeemable common stock was \$3.0 million and \$3.2 million at September 30, 2006 and March 31, 2006, respectively, based on the closing price of the Company's common stock on those dates.

#### **Inventories**

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

#### **Property and Equipment**

Property and equipment are recorded at cost and are depreciated over the estimated useful life ranging from three to eight years. Leasehold improvements are depreciated over the term of the related lease or the estimated useful life of the improvement, whichever is shorter. Beginning April 1, 2006, the Company began depreciating property and equipment using the straight-line method of depreciation. Prior to this date, the Company used the double declining balance method of depreciation. As a result of this change in estimate, depreciation expense declined by \$114,000 and \$194,000 for the three and six months ended September 30, 2006, respectively, resulting in no impact on earnings per share for the three months ended September 30, 2006, and a \$0.01 per share impact on earnings per share for the six months ended September 30, 2006.

## **Goodwill and Long-Lived Assets**

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

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

## **Income Taxes**

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

## **Research and Development Expenditures**

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

## **Shipping and Handling Costs**

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

## **Warranty**

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

## **Repair and Maintenance Costs**

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

## **Reclassifications**

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



## Other Comprehensive Income

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

## Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"), supersedes Accounting Principles Board Opinion No. 25 ("APB 25"), and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values (i.e., pro forma disclosure is no longer an alternative to financial statement recognition). As further discussed in Note 6, the Company adopted SFAS 123R effective April 1, 2006 using the modified prospective method.

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

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application of the statement is encouraged. Generally, this statement will be applied prospectively. The Company is currently evaluating the impact of SFAS 157 and expects to adopt SFAS 157 in the first quarter of its fiscal year ending March 31, 2009.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ("SAB 108"). SAB 108 provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The Company is currently evaluating the impact of SAB 108 and expects to adopt SAB 108 in the first quarter of its fiscal year ending March 31, 2008.

In June 2006, the FASB ratified Emerging Issues Task Force Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* ("EITF 06-3"). The task force reached a conclusion that either method is acceptable; however, if taxes are reported on a gross basis (included as sales) a company should disclose those amounts if significant. EITF 06-3 is effective for the first interim reporting period beginning after December 15, 2006. The Company is currently evaluating the impact of EITF 06-3 and expects to adopt EITF 06-3 in the fourth quarter of the current fiscal year.

## 2. Supplemental Financial Information

### Inventories

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

	September 30, 2006	March 31, 2006
	(In thousands)	
Materials and supplies	\$ 3,750	\$ 2,258
Work in process	200	217
Finished goods	842	339
	<u>\$ 4,792</u>	<u>\$ 2,814</u>

## Goodwill and Intangible Assets

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

	September 30, 2006		March 31, 2006	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
	(In thousands)			
Developed technology	\$ 495	\$ (230)	\$ 495	\$ (179)
Patents	317	(104)	317	(82)
Total	<u>\$ 812</u>	<u>\$ (334)</u>	<u>\$ 812</u>	<u>\$ (261)</u>

Amortization expense for intangible assets subject to amortization was \$37,000 and \$73,000 for the three and six months ended September 30, 2006, respectively, and \$36,000 and \$73,000 for the three and six months ended September 30, 2005, respectively. Future estimated amortization expense for the remainder of the current fiscal year, the next four fiscal years and thereafter is as follows:

Fiscal Year Ending March 31:	
(In thousands)	
Remainder of 2007	\$ 73
2008	147
2009	147
2010	59
2011	46
Thereafter	6
	<u>\$478</u>

At September 30, 2006, goodwill of \$27.8 million was comprised of \$18.0 million associated with the October 2004 merger between the Company and its Iteris Subsidiary; \$9.6 million associated with the acquisitions of the Rockwell International Transportation Systems Group, Meyer Mohaddes Associates, Inc. and the Vigen 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		Six Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(In thousands)			
Balance at beginning of period	\$ 590	\$ 342	\$ 519	\$ 326
Additions charged to cost of sales	155	190	290	265
Warranty claims	(66)	(91)	(130)	(150)
Balance at end of period	<u>\$ 679</u>	<u>\$ 441</u>	<u>\$ 679</u>	<u>\$ 441</u>

## Earnings (Loss) Per Share

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

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
(In thousands, except per share amounts)				
Numerator:				
Net income (loss)	\$ 732	\$ (155)	\$ 1,011	\$ (881)
Denominator:				
Weighted average common shares used in basic computation	28,882	28,106	28,637	28,084
Dilutive stock options	3,550	—	3,484	—
Dilutive warrants	588	—	573	—
Weighted average common shares used in dilutive computation	33,020	28,106	32,694	28,084
Earnings (loss) per share:				
Basic	\$ 0.03	\$ (0.01)	\$ 0.04	\$ (0.03)
Diluted	\$ 0.02	\$ (0.01)	\$ 0.03	\$ (0.03)

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

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
(In thousands)				
Stock options	568	4,299	547	4,093
Warrants	1,200	983	1,290	872
Convertible debentures	2,729	2,729	2,729	2,729

## 3. Revolving Line of Credit and Long-Term Debt

### Revolving Line of Credit

The Company renewed its line of credit agreement with its primary bank in August 2005, which provided for borrowings of up to \$5.0 million. This line of credit agreement was scheduled to expire on July 31, 2006 but was extended until October 31, 2006.

Subsequent to September 30, 2006, the Company replaced its current facility and entered into a new two year credit facility with a different bank. The new facility provides for combined line of credit and bank term note borrowings of up to \$8.0 million. Under the new credit facility, the Company may borrow against its eligible accounts receivable and eligible inventory, as defined in the credit agreement. Line of credit interest on borrowed amounts is payable monthly at the current stated prime rate plus 1.25%. 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. The new credit facility requires \$2,000 in monthly collateral management fees and includes an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. Additionally, the Company paid a commitment fee of \$40,000 in October 2006 and is obligated to pay an additional \$40,000 on the one year anniversary of the facility. The new credit facility is secured by substantially all of the assets of the Company.

On September 30, 2006, the available credit under the prior line of credit agreement was \$4.4 million, of which \$3.8 million was unused.

## Long-Term Debt

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

	September 30, 2006	March 31, 2006
	(In thousands)	
Convertible debentures, net	\$ 9,307	\$ 9,203
Bank term note	2,084	2,708
Promissory note to landlord	1,292	1,292
Other	98	140
	12,781	13,343
Less current portion	(2,261)	(1,969)
	<u>\$ 10,520</u>	<u>\$ 11,374</u>

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

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

*Bank Term Note.* In October 2004, the Company entered into a \$5.0 million term note payable with a bank. The note is due on May 27, 2008, and provides for monthly principal payments of approximately \$104,000. Interest accrues at the current stated prime rate plus 0.25% (8.50% at September 30, 2006). Subsequent to September 30, 2006 the term note was assumed by the Company's new bank as part of the Company's new \$8.0 million credit facility. The new term note is also due on May 27, 2008 and provides for monthly principal payments of approximately \$104,000. Interest accrues under the new term note at the current stated prime rate plus 1.25%. Amounts due under the term note reduce the Company's ability to borrow against its eligible assets on its line of credit.

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

*Promissory Note to Landlord.* The Company has a \$1.3 million unsecured promissory note payable to the landlord of its Anaheim headquarters. Under the terms of the note agreement, interest is payable quarterly and accrues at a rate of prime plus 2.0% (10.25% at September 30, 2006). Beginning on October 1, 2006, the Company is required to make four equal quarterly payments of principal and accrued interest. All outstanding accrued interest and principal becomes payable in full on July 1, 2007. The first principal payment of approximately \$323,000 was made on October 5, 2006.

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

<u>Fiscal Year Ending March 31,</u>	
(In thousands)	
Remainder of 2007	\$ 1,292
2008	1,939
2009	243
2010	9,850
	<u>\$ 13,324</u>
Less: unamortized debt discount	(543)
	<u>\$ 12,781</u>

#### **4. Common Stock Warrants**

On September 27, 2006, the Company issued warrants to purchase an aggregate 246,250 shares of common stock at an exercise price of \$3.25 with a five year life to an existing shareholder in exchange for the early exercise of 1,250,000 outstanding warrants with an exercise price of \$1.61. The new warrants are immediately exercisable and are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price greater than or equal to two times the exercise price of the warrants. The fair value of the new warrants was \$320,000 calculated using the Black-Scholes-Merton ("BSM") option-pricing formula. The warrants were considered a cost of raising capital and were recorded in equity.

In connection with the issuance of the new warrants, the Company is party to a registration rights agreement that contains provisions under which the Company could be subjected to liquidated damages should it fail to maintain effective registration statements for the underlying shares of common stock. These warrants have been accounted for within equity in the condensed consolidated balance sheet in accordance with EITF 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and, accordingly, no liabilities have been recorded in connection therewith. As of September 30, 2006, no liquidated damages were payable under the provisions of the registration rights agreement associated with these warrants.

#### **5. Commitments and Contingencies**

##### **Litigation and Other Contingencies**

On June 29, 2004, a supplier to Mariner Networks, Inc., a former subsidiary of the Company that was discontinued in the fiscal year ended March 31, 2002, filed a complaint in Orange County Superior Court against the Company alleging various breaches of written contract claims arising out of alleged purchase orders. The plaintiff in this lawsuit sought monetary damages aggregating approximately \$850,000 plus attorney fees and related costs. On July 20, 2006, the Company entered into a settlement agreement in connection with this matter. The dispute was settled in full for \$688,000 payable as follows: (i) the Company issued 88,912 shares of the Company's common stock on August 18, 2006 valued at \$213,000 based on the closing sales price of the Company's common stock on the date of issuance; (ii) the Company made a cash payment of \$125,000 on October 20, 2006; and (iii) the Company is obligated to pay \$350,000 in cash in equal monthly installments of \$9,700 over the next three years beginning in November 2006. In connection with this settlement, the Company has recorded a charge of \$636,000, representing the fair value of the settlement, within other expense in the accompanying condensed consolidated statement of operations for the six months ended September 30, 2006.

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

Furthermore, from time to time, the Company has experienced unforeseen developments in contingencies related to its former subsidiaries. For example, the Company has been the subject of a number of routine tax audits for time periods and jurisdictions related to the businesses of its former subsidiaries, some of which are still in process. Although the development and ultimate outcome of these and other unforeseen matters cannot be predicted with any certainty, management does not believe that the Company is presently involved in any matters related to its former subsidiaries that would have a material adverse effect on the Company's consolidated results of operations, financial position or cash flows.

## Operating Lease Commitments

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

<u>Fiscal Year Ending March 31,</u> <u>(In thousands)</u>	
Remainder of 2007	\$ 761
2008	983
2009	146
2010	85
2011	43
Total	<u>\$2,018</u>

## Inventory Purchase Commitments

At September 30, 2006, the Company had firm commitments to purchase inventory in the amount of \$1.5 million during the third and fourth quarters of its fiscal year ending March 31, 2007.

## 6. Stock-Based Compensation

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

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

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

The following table illustrates the impact of adopting SFAS 123R:

	<u>Three Months Ended</u> <u>September 30, 2006</u>	<u>Six Months Ended</u> <u>September 30, 2006</u>
	<u>(In thousands, except per share amounts)</u>	
Income before income taxes	\$ (39)	\$ (94)
Net income	\$ (39)	\$ (94)
Basic and diluted earnings per share	\$ 0.00	\$ 0.00

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

	Three Months Ended September 30, 2005	Six Months Ended September 30, 2005
	(In thousands, except per share amounts)	
Net loss — as reported	\$ (155)	\$ (881)
Add: Stock-based compensation expense included in net loss — as reported	258	523
Deduct: Total stock-based compensation expense determined under fair value based method for all awards	(364)	(735)
Net loss — pro forma	<u>\$ (261)</u>	<u>\$ (1,093)</u>
Basic and diluted loss per share — as reported	\$ (0.01)	\$ (0.03)
Basic and diluted loss per share — pro forma	<u>\$ (0.01)</u>	<u>\$ (0.04)</u>

The Company's 1997 Stock Incentive Plan (the "Plan") provides that options to purchase shares of the Company's unissued common stock may be granted to directors, associates and consultants to the Company at exercise prices which are equal to or greater than the fair market value of the Company's common stock on the date of grant. Options expire ten years after the date of grant or 90 days after termination of employment and generally vest ratably at the rate of 25% on each of the first four anniversaries of the grant date. New shares are issued to satisfy stock option exercises under the Plan. As of September 30, 2006, options to purchase 1.5 million shares of the Company's common stock were outstanding under the Plan.

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

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

A summary of activity in the Plans for the six months ended September 30, 2006 is as follows:

Options	Weighted Average Exercise Price	Weighted Average Remaining Life (In Years)	Aggregate Intrinsic Value
(In thousands, except per share amounts)			
Options outstanding at March 31, 2006	6,977	\$ 1.42	3.97
Granted	169	\$ 2.33	N/A
Exercised	(191)	\$ 1.16	N/A
Forfeited	(18)	\$ 2.64	N/A
Expired	(24)	\$ 2.50	N/A
Options outstanding at September 30, 2006	<u>6,913</u>	<u>\$ 1.44</u>	<u>3.62</u>
Vested and expected to vest at September 30, 2006	<u>6,839</u>	<u>\$ 1.43</u>	<u>3.56</u>
Options exercisable at September 30, 2006	<u>6,462</u>	<u>\$ 1.38</u>	<u>3.26</u>
Options exercisable at September 30, 2006 pursuant to a change-in-control	<u>6,913</u>	<u>\$ 1.44</u>	<u>3.62</u>

At September 30, 2006, there were 106,000 shares of common stock available for grant under the Plan.

For the six month periods ended September 30, 2006 and 2005, the Company received \$224,000 and \$153,000, respectively, in cash from the exercise of stock options. Total stock-based compensation expense for the three and six months ended September 30, 2006 was \$74,000 and \$174,000, respectively. No income tax benefit was realized from activity in the Plans during the six months ended September 30, 2006 and 2005.

At September 30, 2006, there was \$780,000 of total unrecognized compensation expense related to unvested stock options. This expense is expected to be recognized over a weighted-average period of approximately 2.9 years.

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

	<u>Three Months</u> <u>Ended September 30,</u>		<u>Six Months</u> <u>Ended September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Dividend yield	0.0	0.0	0.0	0.0
Expected life — years	7.0	7.0	7.0	7.0
Risk-free interest rate	4.7%	5.5%	4.8%	5.5%
Expected volatility of common stock	0.89	0.50	0.89	0.50

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

	<u>Three Months</u> <u>Ended September 30,</u>		<u>Six Months</u> <u>Ended September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	<u>(In thousands, except per share amounts)</u>			
Weighted average grant date fair value per share	\$ 2.01	\$ 1.82	\$ 1.86	\$ 1.82
Intrinsic value of options exercised	\$ 63	\$ 89	\$ 225	\$ 179
Total fair value of options vested during the period	\$ 134	\$ 879	\$ 517	\$ 1,352

## 7. Business Segment Information

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



The following table sets forth selected unaudited financial information for the Company's reportable segments for the three and six months ended September 30, 2006 and 2005:

	Roadway Sensors	Automotive Sensors	Transportation Systems	Total
(In thousands)				
<b>Three Months Ended September 30, 2006</b>				
Product revenue from external customers	\$ 6,961	\$ 1,658	\$ —	\$ 8,619
Service and other revenue from external customers	—	704	5,143	5,847
Depreciation and amortization	20	34	34	88
Segment income (loss)	1,601	(527)	707	1,781
<b>Three Months Ended September 30, 2005</b>				
Product revenue from external customers	\$ 5,798	\$ 1,472	\$ —	\$ 7,270
Service and other revenue from external customers	—	705	4,740	5,445
Depreciation and amortization	33	48	68	149
Segment income (loss)	878	(608)	600	870
<b>Six Months Ended September 30, 2006</b>				
Product revenue from external customers	\$ 13,477	\$ 2,996	\$ —	\$ 16,473
Service and other revenue from external customers	—	1,450	10,359	11,809
Depreciation and amortization	39	68	62	169
Segment income (loss)	3,102	(1,161)	1,365	3,306
<b>Six Months Ended September 30, 2005</b>				
Product revenue from external customers	\$ 11,145	\$ 3,199	\$ —	\$ 14,344
Service and other revenue from external customers	—	1,156	9,294	10,450
Depreciation and amortization	63	82	151	296
Segment income (loss)	1,663	(1,308)	1,096	1,451

The following table reconciles segment income to consolidated income (loss) before income taxes:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
Total income for reportable segments	\$ 1,781	\$ 870	\$ 3,306	\$ 1,451
Unallocated amounts:				
Corporate expenses	(651)	(936)	(1,431)	(1,835)
Other income (expense), net	45	86	(645)	38
Interest expense, net	(424)	(358)	(810)	(710)
Income (loss) before income taxes	\$ 751	\$ (338)	\$ 420	\$ (1,056)

## 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 in Part II, Item 1A of this report, before deciding to invest in our company or to maintain or increase your investment. We undertake no obligation to revise or update publicly any forward-looking statement for any reason.*

### Overview

We are a 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, transportation management and traveler information systems and other engineering and consulting 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 traffic controller to more efficiently allocate 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 25,000 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 trucks, including Mercedes, MAN, Iveco, DAF, Scania, Freightliner and International. In North America our LDW systems are sold primarily to truck fleets, and to date, 36 U.S. heavy truck fleets have selected our LDW systems, representing an estimated 19,000 vehicles. In September 2003, we entered into an agreement with Valeo Schalter and Sensoren 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 discussions to provide our LDW system to other passenger car OEMs; however, we cannot assure you that such discussions 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. Our Transportation management systems business is expanding partly due to the passage of the Federal Highway Bill combined with expansion of transportation funds at state and local agencies throughout the country.

We currently operate in three reportable segments: Roadway Sensors, Automotive 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 Automotive 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.

### **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our unaudited condensed consolidated financial statements included herein, which have been prepared in accordance with 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, the recoverability of long-lived assets and goodwill, accounting for stock-based compensation related to SFAS 123R, and other contingencies. 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 systems, 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.

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 record 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 anticipated 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.* We generally 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 adjustments to our valuation allowance may create fluctuations in our overall effective tax rate from quarter to quarter.

*Stock-Based Compensation.* We adopted SFAS No. 123R (revised 2004), *Share-Based Payment* ("SFAS 123R"), effective April 1, 2006. Prior to April 1, 2006, we followed the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*, and, accordingly, accounted for our stock-based compensation plans using the intrinsic value method under Accounting Principles Board Opinion No. 25 ("APB 25") and related interpretations.

SFAS 123R requires all stock-based payments, including grants of employee stock options, to be recognized in the

statement of operations as an expense, based on their grant date fair values with such fair values amortized over the requisite service period. We elected to utilize the modified prospective method for the transition to SFAS 123R. Under the modified prospective method, SFAS 123R applies to all awards granted or modified after the date of adoption. In addition, under the modified prospective method, compensation expense will be recognized for all stock-based compensation awards granted prior to but not yet vested as of April 1, 2006, based on grant-date fair values estimated in accordance with the original provisions of SFAS 123.

In implementing SFAS 123R, we have used the Black-Scholes-Merton ("BSM") option-pricing formula to estimate the fair value of stock-based awards granted subsequent to April 1, 2006. Our assumptions under the BSM formula include the following: expected volatilities are based on the historical volatility of our stock price, the expected life of options is derived based on the historical life of our options, and the risk-free rate for periods within the expected life of the option is based on the U.S. Treasury interest rates in effect at the time of grant. Additionally, SFAS 123 did not require the estimation of forfeitures in the calculation of stock compensation expense; however, SFAS 123R does require such estimation and upon adoption of SFAS 123R, we changed our methodology to include an estimate of forfeitures. Future stock-based compensation expense in any particular quarter or year could be affected by changes in our assumptions or changes in market conditions.

## 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 September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Net sales and contract revenues:				
Net sales	64.4%	62.7%	63.4%	62.5%
Contract revenues	35.6	37.3	36.6	37.5
Total net sales and contract revenues	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of net sales	36.6	33.3	35.5	32.2
Cost of contract revenues	22.2	23.9	23.2	24.3
Gross profit	41.2	42.8	41.3	43.5
Operating expenses:				
Selling, general and administrative	27.5	32.1	28.2	31.9
Research and development	5.3	10.8	6.3	12.6
Deferred compensation plan	0.3	0.1	(0.1)	0.3
Amortization of intangible assets	0.3	0.3	0.3	0.3
Total operating expenses	33.4	43.3	34.7	45.1
Operating income (loss)	7.8	(0.5)	6.6	(1.6)
Non-operating income (expense):				
Other income (expense), net	0.3	0.7	(2.3)	0.2
Interest expense, net	(2.9)	(2.8)	(2.8)	(2.9)
Income (loss) before income taxes	5.2	(2.6)	1.5	(4.3)
Income tax benefit (provision)	(0.1)	1.4	2.1	0.7
Net income (loss)	5.1%	(1.2)%	3.6%	(3.6)%

## Analysis of Quarterly Results of Operations

*Net Sales and Contract Revenues.* Net sales are comprised of Roadway Sensor sales, which are derived from sales of our Vantage video detection systems; and Automotive Sensor sales, which are derived from sales of AutoVue LDW systems, technology access fees, contract engineering revenue and royalty revenue generated from AutoVue related activities. Contract revenues consist entirely of Transportation Systems revenues, which are generated from systems integration and ITS consulting services with federal, state, county and municipal agencies. We currently have a diverse customer base with our largest customer constituting 9.6% and 10.1% of total net sales and contract revenues in the three and six months ended September 30, 2006.

Total net sales and contract revenues increased 13.8% to \$14.5 million and 14.1% to \$28.3 million for the three and six months ended September 30, 2006, respectively, compared to \$12.7 million and \$24.8 million in the corresponding periods in the prior fiscal year. This increase was driven by increased net sales in both the Roadway Sensors and Automotive Sensors businesses as well as increased contract revenues in the Transportation Systems business, as discussed below.

Net sales increased 16.9% to \$9.3 million and 15.6% to \$17.9 million for the three and six months ended September 30, 2006, respectively, compared to \$8.0 million and \$15.5 million in the corresponding periods of the prior fiscal year. This increase was driven by a 20.1% and a 20.9% increase in Roadway Sensors net sales in the three and six months ended September 30, 2006, respectively, over the corresponding periods in the prior year as we continue to experience positive reaction to recently introduced Vantage product offerings such as eAccess and color cameras, as well as higher governmental spending which we believe is related to the passage of the Federal Highway Bill in August 2005. In addition to the increase in Roadway Sensors net sales, Automotive Sensors net sales increased 8.5% and 2.1% in the three and six months ended September 30, 2006, respectively, over the corresponding periods in the prior year primarily as a result of an increase in sales of our LDW systems in the North American aftermarket and an increase in revenues generated through engineering activities in the passenger car market. Despite an increase of 14.7% in sales of our LDW systems to the heavy truck market for the three months ended September 30, 2006 compared to the same period in the prior year, sales of our LDW systems to this market have decreased by 4.7% for the six months ended September 30, 2006 compared to the same period in the prior year. The higher level of sales in the prior fiscal year occurred largely as a result of our largest Automotive Sensors customer purchasing approximately \$1.0 million of spare LDW systems in the prior year in anticipation of the changeover to the next generation LDW system. \$400,000 of these LDW systems were purchased in the first quarter of the prior fiscal year and resulted in unusually high volumes for this customer in that period. Such purchases of spare systems did not occur in the three and six months ended September 30, 2006, and are not expected to occur for at least the remainder of this current fiscal year. Additionally, our largest customer benefited from volume pricing discounts which became effective January 1, 2006 and negatively impacted our net sales for Automotive Sensors. The reduced level of sales to our largest Automotive Sensors hardware customer was somewhat offset by a 166% increase in sales of aftermarket LDW systems in North America for the six months ended September 30, 2006. Two of the largest European truck manufacturers also recently announced the launch of our LDW system as an option on heavy duty truck models, which may positively impact our LDW sales in the current fiscal year. While we have enjoyed recent success in signing new customers in the truck market, we have experienced a decline in sales from our largest Automotive Sensors hardware customer, which we have not been able to overcome through sales to new customers in North America or Europe. We cannot assure you that this trend will not continue.

Royalty revenues from Valeo for sales of our LDW systems for the passenger car market remained relatively insignificant in the current quarter. Our LDW systems are now offered as an option on three Infiniti models. While Valeo is currently in discussions to offer our LDW systems on other passenger car platforms, we cannot assure you that Valeo will be successful in these efforts.

Contract revenues increased 8.5% to \$5.1 million and 11.5% to \$10.4 million for the three and six months ended September 30, 2006, respectively, as compared to \$4.7 million and \$9.3 million in the corresponding periods of the prior fiscal year. This increase was largely due to increased funding at the federal, state and local levels throughout the country. In response to this growth in funding, we have increased our Transportation Systems staff by 12% in the six months ended September 30, 2006. We expect to continue to increase our Transportation Systems staff over the next couple quarters, although not at the same rate as in the six months ended September 30, 2006. We believe the ability of our Transportation Systems business to grow and successfully win and service new contracts will be highly dependent upon our continued success in recruiting and retaining qualified personnel. All of our contract revenues are derived from work performed in North America under a broad range of fixed price and cost plus fixed fee contracts. In September 2006 we were awarded a \$9.8 million contract from the Federal Highway Administration ("FHWA"), which covers a period of two years beginning April 2007 and contains renewal options extending through 2012. Although this contract is not expected to substantially affect the trend in contract revenues in our Transportation Systems business and although we cannot assure you that the full face amount of the contract will be spent or that any of the options will be exercised, this contract does help solidify our future FHWA business.

*Gross Profit.* Total gross profit increased 9.5% to \$6.0 million and 8.1% to \$11.7 million for the three and six months ended September 30, 2006, respectively, as compared to \$5.4 million and \$10.8 million in the corresponding periods of the prior fiscal year. Total gross profit as a percent of net sales and contract revenues decreased to 41.2% and 41.3% for the three and six months ended September 30, 2006, respectively, as compared to 42.8% and 43.5% in the corresponding periods of the prior fiscal year.

Gross profit as a percent of net sales was 43.2% and 43.9% for the three and six months ended September 30, 2006, respectively, compared to 46.9% and 48.4% in the corresponding periods of the prior fiscal year. This decrease was primarily due to volume discounts given to our largest Automotive Sensors hardware customer, increased product support activities in our Roadway Sensors business, an increased level of lower margin engineering services provided to our strategic partner Valeo in the current year period and the mix of products sold in the current quarter. Gross profit as a percent of net sales generally fluctuates in any specific quarter based on customer mix. Gross profit as a percent of net sales has declined over the last six quarters from a high of 50.2% in the first quarter of our prior fiscal year to 43.2% reported for the current quarter ended September 30, 2006 mainly as a result of the above.

Gross profit as a percent of contract revenues increased to 37.5% and 36.8% for the three and six months ended September 30, 2006, respectively, compared to 35.9% and 35.4% in the corresponding periods of the prior fiscal year. The increase in gross profit as a percent of contract revenues in the current periods was primarily due to a continued focus on higher margin contracts and a favorable contract mix.

*Selling, General and Administrative Expense.* Selling, general and administrative expense decreased 2.5% and increased 0.9% to \$4.0 million and \$8.0 million (or 27.5% and 28.2% of total net sales and contract revenues) in the three and six months ended September 30, 2006, respectively, compared to \$4.1 million and \$7.9 million (or 32.1% and 31.9% of total net sales and contract revenues) in the corresponding periods of the prior fiscal year. Although selling, general and administrative expense was relatively flat year-over-year in absolute dollar terms, the three and six months ended September 30, 2006, included legal expenses of approximately \$90,000 and \$230,000, respectively, associated with the settlement of litigation described in Note 5 to the accompanying condensed consolidated financial statements. No further significant legal costs are expected to be incurred related to this matter. In the coming quarters and next fiscal year, we anticipate increased selling, general and administrative expense related to our efforts to comply with the internal control attestation requirements of the Sarbanes-Oxley Act, with which we must begin to comply in our fiscal year ending March 31, 2008.

*Research and Development Expense.* Research and development expense decreased 43.7% and 43.1% to \$771,000 and \$1.8 million (or 5.3% and 6.3% of total net sales and contract revenues) in the three and six months ended September 30, 2006, respectively, compared to \$1.4 million and \$3.1 million (or 10.8% and 12.6% of total net sales and contract revenues) in the corresponding periods of the prior fiscal year. The decrease in research and development expense was largely a result of higher than anticipated costs in the prior year period in Automotive Sensors as we expended significant development resources in qualifying the next generation LDW system with our largest customer. Additionally, in the current year, there has been a slight shift in engineering resources from research and development activities to product support activities as a result of new product introductions and improvements in Roadway Sensors. Costs associated with product support activities are included in cost of net sales rather than research and development expense.

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

*Deferred Compensation Plan Expense.* During the three and six month periods ended September 30, 2006, we recorded a non-cash benefit of \$34,000 and expense of \$32,000, respectively, related to the change in value of 310,510 shares of our common stock held in trust by our deferred compensation savings plan. This compares to a non-cash expense of \$16,000 and \$78,000 recorded in the three and six month periods ended September 30, 2005, respectively. We expect to continue to experience non-cash expense or benefit in future periods as the value of the assets held in our deferred compensation savings plan fluctuates.

*Other Income (Expense), Net.* Other income (expense), net includes the following:

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Six Months Ended</u> <u>September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(In thousands)			
Settlement of lawsuit	\$ 53	\$ —	\$ (635)	\$ —
Other	(8)	86	(10)	38
Other income (expense), net	<u>\$ 45</u>	<u>\$ 86</u>	<u>\$ (645)</u>	<u>\$ 38</u>

Other income (expense), net for the six months ended September 30, 2006 primarily reflects \$635,000 of expense recorded in connection with the settlement of litigation described in Note 5 to the accompanying condensed consolidated financial statements.

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

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands)			
Interest expense	\$ (338)	\$ (272)	\$ (637)	\$ (537)
Amortization of debt discount	(52)	(52)	(104)	(104)
Amortization of deferred finance costs	(34)	(34)	(69)	(69)
Interest expense, net	<u>\$ (424)</u>	<u>\$ (358)</u>	<u>\$ (810)</u>	<u>\$ (710)</u>

Interest expense increased 18.4% and 14.1% for the three and six months ended September 30, 2006, respectively, compared to the corresponding periods in the prior fiscal year primarily as a result of a higher level of borrowings on our line of credit in the current year.

*Income Taxes.* During the three and six months ended September 30, 2006, we recognized income tax expense of \$19,000 and an income tax benefit of \$591,000, respectively, as compared to an income tax benefit of \$183,000 and \$175,000 in the three and six months ended September 30, 2005, respectively. The tax benefit recorded in the six months ended September 30, 2006 was based on an estimated annual effective tax rate of 1.9% applied to the pre-tax income for the six months ended September 30, 2006, as well as a \$599,000 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 \$1.6 million at March 31, 2006 to \$2.2 million at September 30, 2006. 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 cause our future overall effective tax rate in any given period to fluctuate from prior effective tax rates, estimated annual effective tax rates and statutory tax rates.

## Liquidity and Capital Resources

### Cash Flows

We have historically financed our operations with a combination of cash flows from operations, borrowings under credit facilities and the sale of equity securities. We currently rely on cash flows from operations and borrowings on a line of credit facility to fund our operations. At September 30, 2006, we had \$6.1 million in working capital, which included borrowings of \$577,000 on our revolving line of credit and \$19,000 in cash and cash equivalents. This compares to working capital of \$3.3 million at March 31, 2006, which included borrowings of \$2.7 million on our revolving line of credit and \$131,000 in cash and cash equivalents. Our operations provided \$135,000 of cash during the six months ended September 30, 2006, primarily as a result of \$1.0 million in net income and an increase in accounts payable due to the timing of payments offset by an increase in inventory levels of \$2.0 million in the current fiscal year to support sales growth. During the six months ended September 30, 2005, our operations provided \$41,000 in cash, primarily as a result of planned decreases in inventory levels.

Our investing activities for the six months ended September 30, 2006 and 2005, consisted entirely of purchases of property and equipment, which aggregated \$240,000 and \$386,000, respectively.

Cash used in financing activities was \$7,000 in the six months ended September 30, 2006, which was largely the result of net payments on our line of credit and long-term debt of \$2.8 million offset by cash inflows of \$2.7 million from the exercise of outstanding stock options and warrants to purchase our common stock. As discussed in Note 4 to the accompanying condensed consolidated financial statements, approximately \$2.0 million of the \$2.7 million was raised through the exercise of 1,250,000 outstanding warrants. During the six months ended September 30, 2005, financing activities provided \$299,000 of cash, which was comprised of net borrowings on our line of credit and long-term debt of \$109,000 and cash inflows of \$190,000 from the exercise of outstanding stock options and warrants to purchase our common stock.



## Borrowings

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

	At September 30, 2006 (In thousands)
Convertible debentures, net	\$ 9,307
Bank term note	2,084
Promissory note to landlord	1,292
Other	98
	<u>\$ 12,781</u>

We renewed our credit agreement with our bank in August 2005, which provided for borrowings of up to \$5.0 million. This credit agreement was scheduled to expire on July 31, 2006, but was extended until October 31, 2006. At September 30, 2006, we had \$4.4 million available under the revolving line of credit, of which \$3.8 million was unused.

Subsequent to September 30, 2006, we replaced our current facility and entered into a new two year credit facility with a different bank. The new facility provides for combined line of credit and bank term note borrowings of up to \$8.0 million. Under the new credit facility, we may borrow against our eligible accounts receivable and eligible inventory, as defined in the credit agreement. Interest on borrowed amounts is payable monthly at the current stated prime rate plus 1.25%. Additionally, we are 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. The new credit facility requires \$2,000 in monthly collateral management fees and includes an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. Additionally, we paid a commitment fee of \$40,000 in October 2006 and are obligated to pay an additional \$40,000 on the one year anniversary of the facility. The new credit facility is secured by substantially all of the assets of the Company.

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

## Contractual Obligations

Our contractual obligations are as follows at September 30, 2006:

	Payments Due by Period					Total
	2007	2008	2009	2010	2011	
	(In thousands)					
Line of credit	\$ 577	\$ —	\$ —	\$ —	\$ —	\$ 577
Notes payable	1,292	1,939	243	—	—	3,474
Convertible debentures	—	—	—	9,850	—	9,850
Operating leases	761	983	146	85	43	2,018
Total	<u>\$ 2,630</u>	<u>\$ 2,922</u>	<u>\$ 389</u>	<u>\$ 9,935</u>	<u>\$ 43</u>	<u>\$ 15,919</u>

At September 30, 2006, we had firm commitments to purchase inventory in the amount of \$1.5 million during the third and fourth quarters of our fiscal year ending March 31, 2007.

## Off Balance Sheet Arrangements

In May 2004, we issued subordinated convertible debentures in an aggregate original principal amount of \$10.1 million. These debentures are due in full on May 19, 2009 and are convertible into shares of our common stock at an initial conversion price of \$3.61 per share. At September 30, 2006, \$9.9 million of these convertible debentures remained outstanding. Because these debentures are conventionally convertible, we have not separately accounted for the conversion feature and, accordingly, no separate amounts are presented in our condensed consolidated financial statements in connection with this conversion feature.

At September 30, 2006, outstanding warrants to purchase an aggregate of 62,500 shares of our common stock at an exercise price of \$1.95 per share and outstanding warrants to purchase an aggregate of 246,250 shares of our common stock at an exercise price of \$3.25 were callable by us if the closing sales price of our common stock for 20 consecutive days is equal to or greater than two times the exercise price of the warrants. Outstanding warrants to purchase an aggregate of 75,000 shares of our common stock at an exercise price of \$5.00 per share were callable by us if the price of our common stock for 20 consecutive days is equal to or greater than one and a half times the exercise price of the warrants.

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

#### **Recent Accounting Pronouncements**

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

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application of the statement is encouraged. Generally, this statement will be applied prospectively. We are currently evaluating the impact of SFAS 157 and expect to adopt SFAS 157 in the first quarter of our fiscal year ending March 31, 2009.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ("SAB 108"). SAB 108 provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. We are currently evaluating the impact of SAB 108 and expect to adopt SAB 108 in the first quarter of our fiscal year ending March 31, 2008.

In June 2006, the FASB ratified Emerging Issues Task Force Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* ("EITF 06-3"). The task force reached a conclusion that either method is acceptable; however, if taxes are reported on a gross basis (included as sales) a company should disclose those amounts if significant. EITF 06-3 is effective for the first interim reporting period beginning after December 15, 2006. We are currently evaluating the impact of EITF 06-03 and expect to adopt EITF 06-3 in the fourth quarter of our current fiscal year.

#### **Seasonality**

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

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

Our exposure to interest rate risk is limited to our line of credit, bank term note and a promissory note to our landlord. Our line of credit, bank term note and promissory note to our landlord bear interest based on the prevailing prime rate (8.25% at September 30, 2006). We do not believe that a 10% increase in the interest rate on our line of credit, bank term note and promissory note to our landlord (from 9.50% to 10.45% on the line of credit, from 9.50% to 10.45% on the bank term note and from 10.25% to 11.28% on the promissory note to our landlord) would have a material impact on our financial position, operating results or cash flows. In addition, we believe that the carrying value of our outstanding debt approximates fair value.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

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

#### **Changes in Internal Controls**

During the 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.

Effective April 1, 2006, we implemented a new enterprise resource planning system that thus far has not resulted in any material changes in 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 Historically Experienced Substantial Losses And May Continue To Experience Losses For The Foreseeable Future.** Although we had net income of \$80,000 from continuing operations in the year ended March 31, 2006, we experienced net losses from continuing operations of \$11.3 million and \$1.9 million in the years ended March 31, 2005 and 2004, respectively. While we have divested other business units, 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 \$590,000 in the year ended March 31, 2005 to negative cash flows from operations of \$718,000 in the year ended March 31, 2004. Additionally, we failed to meet certain debt covenants under our prior credit agreement in two of our last six fiscal quarters, but replaced that credit facility in October 2006 as further described in Note 3 to the accompanying condensed consolidated financial statements.

At September 30, 2006, we had \$19,000 of cash and cash equivalents and relied on our line of credit to fund our operations. We may need to raise additional capital in the near future to fund our operations or to repay indebtedness. Such additional capital may be raised through bank borrowings, or other debt or equity financings. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all, and such additional financing may result in further dilution to our stockholders.

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

- market acceptance of our products and product enhancements, and the overall level of sales of our products;
- our ability to control costs;
- the supply of key components for our products;
- our ability to 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, including potential delays in government contract awards;
- 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 fiscal year ending March 31, 2008 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, 2008 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 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 Which Could Materially And Adversely Impact Our Sales And Financial Results And The Ultimate Acceptance Of Our Products.** It is possible that we could experience unforeseen quality control issues or part shortages as we increase production to meet current demand of our products. We have historically used single suppliers for certain of our components in our AutoVue and Vantage products. Should any such delay or disruption occur, our future sales will likely be materially and adversely affected.

Additionally, we rely heavily on select contract manufacturers to produce many of our products. Although we believe our contract manufacturers have sufficient capacity to meet our production schedules for the foreseeable future and we believe we could find alternative contract manufacturing sources if necessary, we could experience a production gap if for any reason our contract manufacturers were unable to meet our production requirements.

**We 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.

**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. In particular, the future success of our Transportation Systems business will depend on our ability to hire additional qualified engineers and planners. Competition for qualified employees, particularly development engineers, is intense. We may not be able to continue to attract and retain sufficient numbers of such highly skilled employees. Our inability to attract and retain additional key employees or the loss of one or more of our current key employees could adversely affect our business, financial condition and results of operations.

**If We Are Unable To Develop And Introduce New Products And Product Enhancements Successfully And In A Cost-Effective And Timely Manner, Or Are Unable To Achieve Market Acceptance Of Our New Products, Our Operating Results Would Be Adversely Affected.** We believe our revenue growth and future operating results will depend on our ability to complete development of new products and enhancements, introduce these products in a timely, cost-effective manner, achieve broad market acceptance of these products and enhancements, and reduce our product costs. We cannot guarantee the success of these products and we may not be able to introduce any new products or any enhancements to our existing products on a timely basis, or at all. In addition, the introduction of any new products could adversely affect the sales of certain of our existing products.

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

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

Certain of the components used in our Vantage and AutoVue products may need to be re-engineered in the next 18 months as the industry is moving towards a standard of using lead-free components. We cannot assure you as to the timing of the adoption of this new standard or our ability to successfully redesign our products to incorporate compliant components and gain market acceptance of such redesigned products. In addition, if the standard is adopted earlier than anticipated we may experience a shortage of Vantage and AutoVue products as a result of potential scarcity of lead-free components.

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

**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. We have experienced more competition in our Vantage business in fiscal 2007 as the Department of Transportation in one of our largest sales territories has recently moved to a multisource contracting environment from one in which Iteris was the sole supplier. In addition, one of the other developers of LDW systems was recently acquired by a larger company. While this developer has not been a material competitor to date, we may experience more competition from this provider as a result of its greater access to resources from its acquirer, and additional competitors may enter this market in the future.

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.

**An Economic Slowdown Or The Significant Military Operations In The Middle East Or Elsewhere May Impact Government Funding Or Consumer Spending, Causing A Decline In Our Revenues.** In the near term, the funding of U.S. military operations in the Middle East or elsewhere may cause disruptions in funding of government contracts. Since military operations of such magnitude are not routinely included in U.S. defense budgets, supplemental legislative funding actions are often required to finance such operations. Even when such legislation is enacted, it may not be adequate for ongoing operations, causing other government sources to be temporarily or permanently diverted. Since a significant portion of our sales are derived from contracts with government agencies, such diversion of funds could produce interruptions in funding or delays in receipt of our contracts, causing disruptions and adversely affecting our revenue and operations.

Concerns about the recent international conflicts and terrorist and military actions, as well as concerns about inflation, decreased consumer confidence, and reduced corporate profits and capital spending have also 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 (and also may result in decreased sales of automobiles and trucks that incorporate our LDW systems). Such concerns may result in cancellations and rescheduling of backlog. In addition, the recent decline in the U.S. real estate market, particularly in new home construction, could adversely impact new road construction resulting in a decline in Roadway Sensor and Automotive Sensor net sales and Transportation Systems contract revenues. Any of the foregoing political, social and economic conditions make it extremely difficult for our customers, our suppliers and us to accurately forecast and plan future business activities and could result in a decline in our net sales and contract revenues. If such conditions continue or worsen, our business, financial condition and results of operations could be materially and adversely affected.

**New Environmental Regulations May Result In A Decline In Our AutoVue Sales and Royalties.** Recent environmental regulations in Europe are expected to be in place during Fall 2006 which will require more stringent emissions compliance in new trucks manufactured, that could cause a decline in new truck sales in Europe in the near future. Similar regulations have been announced in North America that may impact diesel engines built after January 2007, which could similarly impact North American OEM truck sales in general. As a result, we may experience a decline in our LDW sales to truck OEMs related to these stricter regulations.

**We Depend On Government Contracts And Subcontracts, And Because Many Of Our Government Contracts Are Fixed Price Contracts, Higher Than Anticipated Costs Will Reduce Our Profit And Could Adversely Impact Our Operating Results.** A significant portion of our sales are derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. Government contracts represented approximately 38.3%, 37.4% and 48.2% of our total net sales and contract revenues for the years ended March 31, 2006, 2005 and 2004, 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 and contract revenues in any given quarter. Our inability to address any of the foregoing concerns or the loss or renegotiation of any material government contract could seriously harm our business, financial condition and results of operations.

**Our Quarterly Operating Results Fluctuate As A Result Of Many Factors. Therefore, We May Fail To Meet Or Exceed The Expectations Of Securities Analysts And Investors, Which Could Cause Our Stock Price To Decline.** Our quarterly revenues and operating results have fluctuated and are likely to continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. Factors that could affect our revenues include, among others, the following:

- changes in our pricing policies and the pricing policies of our suppliers and competitors, pricing concessions on volume sales, as well as increased price competition in general;
- the long lead times associated with government contracts or required by vehicle manufacturers;
- delays in government contracts from time to time, including from delays in the allocation of funds to state and local agencies from the U.S. government transportation bill;
- our ability to raise additional capital;
- our ability to control costs;



- the mix of our products and services sold in a quarter, which mix has varied and is expected to continue to vary from time to time;
- seasonality due to winter weather conditions;
- international conflicts and acts of terrorism;
- declines in new home construction and related road construction;
- 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 and cost of components used in the manufacture of our products;
- our success in expanding and implementing our sales and marketing programs;
- the effects of technological changes in our target markets;
- the amount of our backlog at any given time;
- the nature of our government contracts;
- deferrals of customer orders in anticipation of new products, applications or product enhancements;
- risks and uncertainties associated with our international business;
- currency fluctuations and our ability to get currency out of certain foreign countries; and
- general economic and political conditions.

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

**We May Engage In Acquisitions Of Companies Or Technologies That May Require Us To Undertake Significant Capital Infusions And Could Result In Disruptions Of Our Business And Diversion Of Resources And Management Attention.** We have historically acquired, and may in the future acquire, complementary businesses, products and technologies. Acquisitions may require significant capital infusions and, in general, acquisitions also involve a number of special risks, including:

- potential disruption of our ongoing business and the diversion of our resources and management's attention;
- the failure to retain or integrate key acquired personnel;

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

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

**We Have Experienced Growth In Recent Periods. If We Fail To Manage Our Growth Effectively, We May Be Unable To Execute Our Business Plan And May Experience Future Weaknesses In Our Internal Controls.** We have expanded our overall business, particularly in our Vantage and AutoVue product lines. In order to achieve our business objectives, we will need to continue to expand our business and add additional qualified personnel. Such expansion has placed and is expected to continue to place, a significant strain on our managerial, administrative, operational, financial and other resources. If we are unable to successfully manage our growth, our business, financial condition and results of operations will be adversely affected.

To accommodate this growth, we launched a new ERP system in April 2006. Accordingly, we may experience problems commonly experienced by other companies in connection with such implementations, including but not limited to, potential bugs in the system, component or supply delays, training requirements and other integration challenges and delays. Any difficulties we might experience in connection with our new ERP system could have a material adverse effect on our financial reporting system and internal controls.

**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.

**We May Not Be Able To Adequately Protect Or Enforce Our Intellectual Property Rights, Which Could Harm Our Competitive Position.** If we are not able to adequately protect or enforce the proprietary aspects of our technology, competitors could be able to access our proprietary technology and our business, financial condition and results of operations will likely be seriously harmed. We currently attempt to protect our technology through a combination of patent, copyright, trademark and trade secret laws, employee and third party nondisclosure agreements and similar means. Despite our efforts, other parties may attempt to disclose, obtain or use our technologies or systems. Our competitors may also be able to independently develop products that are substantially equivalent or superior to our products or design around our patents. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. As a result, we may not be able to protect our proprietary rights adequately in the United States or abroad.

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

**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.

In addition, options to purchase an aggregate of 1.5 million shares of our common stock at a weighted average price of \$0.53 per share terminate on or prior to September 30, 2007. Our common stock has traditionally been thinly traded. The exercise of these options and the sale of a large number of shares of our common stock could cause our stock price to decline.

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

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

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

**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. For example, we recently entered into a settlement agreement in connection with a lawsuit brought against Mariner Networks, Inc., one of our former subsidiaries, by one of Mariner's suppliers, pursuant to which we issued 88,912 shares of our common stock to this supplier (valued at \$213,000 as of the date of issuance), paid this supplier \$125,000 on October 20, 2006 and are required to pay an additional \$350,000 in 36 equal monthly installments of \$9,700 beginning in November 2006. 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 September 30, 2006, our officers and directors owned approximately 14% of the outstanding shares of our common stock (and approximately 22% 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 September 30, 2006). 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

In connection with our Annual Meeting of Stockholders held on September 14, 2006, the following proxies were tabulated representing 19,902,272 shares of our common stock or 69% of the outstanding shares:

### Proposal I: Election of the Board of Directors

<u>Director Nominee</u>	<u>Total Votes for Each Director</u>	<u>Total Votes Withheld from Each Director</u>
Richard J. Char	19,861,084	41,188
Kevin C. Daly, Ph.D.	19,801,654	100,618
Gary Hernandez	19,859,634	42,638
Jack Johnson	19,849,209	53,063
Dr. Hartmut Marwitz	19,819,851	82,421
Gregory A. Miner	19,845,437	56,835
Abbas Mohaddes	19,819,851	82,421
John W. Seazholtz	19,860,634	41,638
Joel Slutzky	19,843,937	58,335
Thomas L. Thomas	19,858,334	43,938
Paul E. Wright	19,860,634	41,638

### Proposal II: The ratification of McGladrey & Pullen, LLP as the Company's independent auditors for the fiscal year ending March 31, 2007.

	<u>Shares of Common Stock</u>
<b>For</b>	19,839,957
<b>Against</b>	50,436
<b>Abstain</b>	11,879

## ITEM 5. OTHER INFORMATION

None.

## ITEM 6. EXHIBITS

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

<b>Exhibit Number</b>	<b>Description</b>	<b>Where Located</b>
3.1	Amended and Restated Certificate of Incorporation of the registrant	<i>Exhibit 3.1 to the registrant's current report on Form 8-K as filed with the SEC on October 28, 2004</i>
3.2	Bylaws of registrant, as amended	<i>Exhibit 4.2 to the registrant's Registration Statement on Form S-1 (Reg. No. 033-67932) as filed with the SEC on July 6, 1993</i>
3.3	Certificates of Amendment to Bylaws of the registrant dated April 24, 1998 and August 10, 2001	<i>Exhibit 3.4 to the registrant's Annual Report on Form 10-K/A for the year ended March 31, 2003 as filed with the SEC on July 29, 2003</i>
3.4	Certificate of Amendment to Bylaws of registrant dated September 9, 2004	<i>Exhibit 3.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 as filed with the SEC on November 15, 2004</i>
4.1	Specimen of Common Stock Certificate	<i>Exhibit 4.1 to the registrant's Amendment No. 1 to the Registration Statement on Form 8-A as filed with the SEC on December 8, 2004</i>
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	<i>Exhibit 99.1 to the registrant's Registration Statement on Form 8-A/A as filed with the SEC on June 18, 2004</i>
10.1	Warrant Exercise Agreement dated September 27, 2006 by and among the registrant and Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P.	<i>Filed herewith</i>
10.2	Registration Rights Agreement dated September 28, 2006 by and among the registrant and Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P.	<i>Filed herewith</i>
10.3†	National Intelligent Transportation Systems (ITS) Architecture Evolution and Support Award/Contract effective as of October 1, 2006 by and between the registrant and the Federal Highway Administration	<i>Filed herewith</i>

10.4	Loan and Security Agreement effective as of October 16, 2006 by and between the registrant and Silicon Valley Bank	<i>Filed herewith</i>
10.5	Intellectual Property Security Agreement dated October 9, 2006 by and between the registrant and Silicon Valley Bank	<i>Filed herewith</i>
31.1	Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>
31.2	Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>
32.1	Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>
32.2	Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	<i>Filed herewith</i>

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† Confidential treatment has been requested for certain confidential portions of this exhibit pursuant to Rule 24b-2 under the Securities Exchange Act of 1934. In accordance with Rule 24b-2, these confidential portions have been omitted from the exhibit and filed separately with the Securities and Exchange Commission.

## 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: November 14, 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)



## WARRANT EXERCISE AGREEMENT

September 27, 2006

Special Situations Fund III QP, L.P.  
Special Situations Fund III, L.P.  
Special Situations Cayman Fund, L.P.  
Special Situations Private Equity Fund, L.P.  
527 Madison Avenue, Suite 2600  
New York, NY 10022

Attention: Austin W. Marx

Dear Austin:

Reference is hereby made to the Purchase Agreement, dated as of August 7, 2002 (the "Purchase Agreement"), among Iteris, Inc., as the successor to Odetics, Inc. (collectively, the "Company"), and each of Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P., as the successors to the funds originally party thereto (each a "Fund" and, collectively, the "Funds"). Pursuant to the terms of the Purchase Agreement, the Funds hold Warrants (the "Warrants") to purchase an aggregate of 1,250,000 shares of the Common Stock (the "Warrant Shares"), par value \$0.10 per share, of the Company ("Common Stock") at an exercise price of \$1.61 per share. The number of Warrants held by each Fund is set forth in Exhibit A hereto.

Subject to the terms and conditions set forth herein, the Funds hereby exercise their Warrants in full effective on the Closing Date (as defined below). In consideration of such agreement to exercise, on the Closing Date, the Company shall deliver to the Funds the Warrant Shares, registered in the names and in the respective amounts set forth in Exhibit A, and additional warrants (the "New Warrants") to purchase an aggregate of 246,250 shares of Common Stock (subject to adjustment) (the "New Warrant Shares") at an exercise price of \$3.25 per share (subject to adjustment). The New Warrants shall be in substantially the form attached hereto as Exhibit B hereto. The number of New Warrants to be issued to each Fund is set forth in Exhibit A hereto. On the Closing Date, the parties hereto will execute and deliver a Registration Rights Agreement, in substantially the form attached hereto as Exhibit C (the "Registration Rights Agreement"), pursuant to which the Company will provide certain registration rights under the Securities Act of 1933, as amended (the "Act"), and the rules and regulations promulgated thereunder, and applicable state securities laws. In the event that the Closing Date does not occur prior to the close of business on September 29, 2006, this Warrant Exercise Agreement (this "Agreement") shall be null and void.

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As promptly as practicable after the date hereof, the Company shall deliver to Lowenstein Sandler PC, in trust, certificates representing the Warrant Shares and the New Warrants, in the amounts and registered in the names set forth in Exhibit A, such Warrant Shares and New Warrants to be held for release to the Funds only upon payment in full of the aggregate exercise price of the Warrants of \$2,012,500 to the Company by the Funds. Upon such receipt by Lowenstein Sandler PC of the certificates, each Fund shall promptly, but no more than one business day thereafter, cause a wire transfer in same day funds to be sent to the account of the Company as instructed in writing by the Company, in an amount representing such Fund's pro rata portion of the aggregate exercise price as set forth in Exhibit A hereto and shall deliver their Warrants to the Company. On the date the Company receives the aggregate exercise price and the Warrants (the "Closing Date"), the certificates evidencing the Warrant Shares and the New Warrants shall be released to the Funds (the "Closing"). The Closing of the transactions contemplated hereby shall take place at the offices of Lowenstein Sandler PC, 1251 Avenue of the Americas, 18th Floor, New York, New York 10020, or at such other location and on such other date as the Company and the Funds shall mutually agree.

The Company hereby represents and warrants to the Funds that:

- (a) The Company is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation and has all requisite corporate power and authority to carry on its business as now conducted and to own its properties.
- (b) The Company has full corporate power and authority and has taken all requisite corporate action on the part of the Company, its officers, directors and stockholders necessary for (i) the authorization, execution and delivery of this Agreement, the New Warrants and the Registration Rights Agreement (collectively, the "Transaction Documents"), (ii) the authorization of the performance of all obligations of the Company hereunder or thereunder, and (iii) the authorization, issuance (or reservation for issuance) and delivery of the New Warrants and the New Warrant Shares (collectively, the "Securities"). The Transaction Documents constitute the legal, valid and binding obligations of the Company, enforceable against the Company in accordance with their terms, subject to (x) bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability, relating to or affecting creditors' rights generally, (y) laws relating to the availability of specific performance, injunctive relief or other equitable remedies, and (z) the extent the indemnification or contribution provisions contained in the Registration Rights Agreement may be limited by applicable federal or state securities laws.
- (c) Except as disclosed in Schedule 1 hereto, the issuance and sale of the Securities hereunder will not obligate the Company to issue shares of Common Stock or other securities to any other person or entity (other than the Funds) and will not result in the adjustment of the exercise, conversion, exchange or reset price of any outstanding security.

(d) The New Warrants have been duly and validly authorized. Upon the due exercise of the New Warrants (including the payment of the exercise price therefor as specified therein), the New Warrant Shares will be validly issued, fully paid and non-assessable and free and clear of all encumbrances and restrictions, except for restrictions on transfer set forth in the Transaction Documents or imposed by applicable securities laws and except for those created by the Funds. The Company has reserved a sufficient number of shares of Common Stock for issuance upon the exercise of the New Warrants, free and clear of all encumbrances and restrictions, except for restrictions on transfer set forth in the Transaction Documents or imposed by applicable securities laws and except for those created by the Funds.

(e) The execution, delivery and performance by the Company of the Transaction Documents and the offer, issuance and sale of the Securities require no consent of, action by or in respect of, or filing with, any person or entity, governmental body, agency, or official other than filings to be made with the American Stock Exchange, filings that have been made pursuant to applicable state securities laws and post-sale filings pursuant to applicable state and federal securities laws which the Company undertakes to file within the applicable time periods. Subject to the accuracy of the representations and warranties of each Fund set forth herein, the Company has taken all action necessary to exempt (i) the issuance and sale of the Securities, (ii) the issuance of the New Warrant Shares upon due exercise of the New Warrants, and (iii) the other transactions contemplated by the Transaction Documents from the provisions of (A) any stockholder rights plan or other "poison pill" arrangement, (B) any anti-takeover, business combination or control share law or statute binding on the Company or to which the Company or any of its assets and properties may be subject and (C) any provision of the Company's Certificate of Incorporation or Bylaws, that in case of clauses (A) through (C) above is or could reasonably be expected to become applicable to the Funds as a result of the transactions contemplated hereby and that would restrict the ownership, disposition or voting of the Securities by the Funds or the exercise of any right granted to the Funds pursuant to this Agreement or the other Transaction Documents.

(f) The execution, delivery and performance of the Transaction Documents by the Company and the issuance and sale of the Securities will not conflict with or result in a breach or violation of any of the terms and provisions of, or constitute a default under (i) the Company's Certificate of Incorporation or the Company's Bylaws, both as in effect on the date hereof (true and complete copies of which have been made available to the Funds through the EDGAR system), or (ii) (A) any statute, rule, regulation or order of any governmental agency or body or any court, domestic or foreign, having jurisdiction over the Company, any subsidiary or any of their respective assets or properties, or (B) any agreement or instrument to which the Company or any subsidiary is a party or by which the Company or a subsidiary is bound or to which any of their respective assets or properties is subject.

(g) No person or entity will have, as a result of the transactions contemplated by the Transaction Documents, any valid right, interest or claim against or upon the Company, any subsidiary or a Fund for any commission, fee or other

compensation pursuant to any agreement, arrangement or understanding entered into by or on behalf of the Company.

(h) Neither the Company nor any person or entity acting on its behalf has conducted any general solicitation or general advertising (as those terms are used in Regulation D) in connection with the offer or sale of any of the Securities.

(i) Neither the Company nor any of its affiliates, nor any person or entity acting on its or their behalf has, directly or indirectly, made any offers or sales of any Company security or solicited any offers to buy any security, under circumstances that would adversely affect reliance by the Company on Section 4(2) for the exemption from registration for the transactions contemplated hereby or would require registration of the Securities under the Act.

(j) Subject to the accuracy of the representations and warranties of each Fund set forth herein, the offer and sale of the Securities to the Funds as contemplated hereby is exempt from the registration requirements of the Act.

Each of the Funds hereby severally, and not jointly, represents and warrants to the Company that:

(a) Such Fund is a validly existing corporation, limited partnership or limited liability company and has all requisite corporate, partnership or limited liability company power and authority to enter into this Agreement and the other Transaction Documents and to invest in the Securities pursuant to this Agreement.

(b) The execution, delivery and performance by such Fund of the Transaction Documents to which such Fund is a party have been duly authorized and will each constitute the valid and legally binding obligation of such Fund, enforceable against such Fund in accordance with their respective terms, subject to (x) bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability, relating to or affecting creditors' rights generally, (y) laws relating to the availability of specific performance, injunctive relief or other equitable remedies, and (z) the extent the indemnification or contribution provisions contained in the Registration Rights Agreement may be limited by applicable federal or state securities laws.

(c) The Securities to be received by such Fund hereunder will be acquired for such Fund's own account, not as nominee or agent, and not with a view to the resale or distribution of any part thereof in violation of the Act, and such Fund has no present intention of selling, granting any participation in, or otherwise distributing the same in violation of the Act without prejudice, however, to such Fund's right at all times to sell or otherwise dispose of all or any part of such Securities in compliance with applicable federal and state securities laws. Nothing contained herein shall be deemed a representation or warranty by such Fund to hold the Securities for any period of time. Such Fund is not a broker-dealer registered with the Securities and Exchange

Commission under the Securities Exchange Act of 1934, as amended, or an entity engaged in a business that would require it to be so registered.

(d) Such Fund acknowledges that it can bear the economic risk and complete loss of its investment in the Securities and has such knowledge and experience in financial or business matters that it is capable of evaluating the merits and risks of the investment contemplated hereby.

(e) Such Fund has had an opportunity to receive all information related to the Company requested by it and to ask questions of and receive answers from the Company regarding the Company, its business and the terms and conditions of the offering of the Securities. Neither such inquiries nor any other due diligence investigation conducted by such Fund shall modify, limit or otherwise affect such Fund's right to rely on the Company's representations and warranties contained in this Agreement.

(f) Such Fund understands that the Securities are characterized as "restricted securities" under the U.S. federal securities laws inasmuch as they are being acquired from the Company in a transaction not involving a public offering and that under such laws and applicable regulations such securities may be resold without registration under the Act only in certain limited circumstances.

(g) It is understood that, except as provided below, certificates evidencing the Securities may bear the following or any similar legend:

"The securities represented hereby may not be transferred unless (i) such securities have been registered for sale pursuant to the Securities Act of 1933, as amended, (ii) such securities may be sold pursuant to Rule 144(k), or (iii) the Company has received an opinion of counsel reasonably satisfactory to it that such transfer may lawfully be made without registration under the Securities Act of 1933 or qualification under applicable state securities laws."

(h) Such Fund is an accredited investor as defined in Rule 501(a) of Regulation D, as amended, under the Act.

(i) Such Fund did not learn of the investment in the Securities as a result of any general solicitation or general advertising.

(j) No person or entity will have, as a result of the transactions contemplated by the Transaction Documents, any valid right, interest or claim against or upon the Company, any subsidiary or a Fund for any commission, fee or other compensation pursuant to any agreement, arrangement or understanding entered into by or on behalf of such Fund.

Promptly following the date hereof, the Company shall take all necessary action to cause the New Warrant Shares to be listed on the American Stock Exchange

upon official notice of issuance. Further, if the Company applies to have its Common Stock or other securities traded on any other principal stock exchange or market, it shall include in such application the New Warrant Shares and will take such other action as is necessary to cause such Common Stock to be so listed. The Company will use commercially reasonable efforts to continue the listing and trading of its Common Stock on the American Stock Exchange and, in accordance, therewith, will use commercially reasonable efforts to comply in all respects with the Company's reporting, filing and other obligations under the bylaws or rules of such exchange.

Upon the earlier of (i) registration for resale pursuant to the Registration Rights Agreement or (ii) Rule 144(k) becoming available the Company shall (A) deliver to the transfer agent for the Common Stock (the "Transfer Agent") irrevocable instructions that the Transfer Agent shall reissue a certificate representing the New Warrant Shares without legends upon receipt by such Transfer Agent of the legended certificates for such shares, together with either (1) a customary representation by the applicable Fund that Rule 144(k) applies to the shares of Common Stock represented thereby or (2) a statement by the applicable Fund that such Fund has sold the shares of Common Stock represented thereby in accordance with the Plan of Distribution contained in the Registration Statement, and (B) cause its counsel to deliver to the Transfer Agent one or more blanket opinions to the effect that the removal of such legends in such circumstances may be effected under the Act. From and after the earlier of such dates, upon a Fund's written request and compliance by the Fund with the applicable provisions of clause (A)(1) or (A)(2) above, the Company shall promptly cause certificates evidencing the Fund's Securities to be replaced with certificates which do not bear such restrictive legends, and New Warrant Shares subsequently issued upon due exercise of the New Warrants shall not bear such restrictive legends provided the provisions of either clause (i) or clause (ii) above, as applicable, are satisfied with respect to such New Warrant Shares, and provided further that in the case of clause (i) the Registration Statement has not been suspended (including due to an Allowed Delay, as such term is defined in the Registration Rights Agreement) and no stop order has been issued with respect to such Registration Statement prior to the sale or transfer by the Fund giving rise to such transfer request. When the Company is required to cause unlegended certificates to replace previously issued legended certificates, if unlegended certificates are not delivered to a Fund within three (3) business days of delivery by that Fund of legended certificate(s) to the Transfer Agent as provided above (or to the Company, in the case of the New Warrants), the Company shall be liable to the Fund for liquidated damages in an amount equal to 1.0% of the aggregate exercise price paid or payable in respect of the Securities evidenced by such certificate(s) for each thirty (30) day period (or portion thereof) beyond such three (3) business days that the unlegended certificates have not been so delivered.

Unless otherwise provided, any notice required or permitted under this Agreement shall be given in writing and shall be deemed effectively given as hereinafter described (i) if given by personal delivery, then such notice shall be deemed given upon such delivery, (ii) if given by telex or facsimile, then such notice shall be deemed given upon receipt of confirmation of complete transmittal, (iii) if given by mail, then such

notice shall be deemed given upon the earlier of (A) receipt of such notice by the recipient or (B) three days after such notice is deposited in first class mail, postage prepaid, and (iv) if given by an internationally recognized overnight air courier, then such notice shall be deemed given one business day after delivery to such carrier. All notices shall be addressed to the party to be notified at the address as follows, or at such other address as such party may designate by ten days' advance written notice to the other party:

If to the Company:

Iteris, Inc.  
1515 South Manchester Avenue  
Anaheim, California 92802  
Attention: Jack Johnson  
Fax: (714) 780-7857

If to the Funds:

Special Situations Funds  
527 Madison Avenue, Suite 2600  
New York, New York 10022  
Attention: Austin W. Marx  
Fax: (212) 319-6677

The parties hereto shall pay their own costs and expenses in connection herewith, except that the Company shall pay the reasonable fees and expenses of Lowenstein Sandler PC not to exceed \$5,000. Such expenses shall be paid not later than the Closing. The Company shall reimburse the Funds upon demand for all reasonable out-of-pocket expenses incurred by the Funds, including without limitation reimbursement of attorneys' fees and disbursements, in connection with any amendment, modification or waiver of this Agreement or the other Transaction Documents. In the event that legal proceedings are commenced by any party to this Agreement against another party to this Agreement in connection with this Agreement or the other Transaction Documents, the party or parties which do not prevail in such proceedings shall severally, but not jointly, pay their pro rata share of the reasonable attorneys' fees and other reasonable out-of-pocket costs and expenses incurred by the prevailing party in such proceedings.

This Agreement shall be governed by, and construed in accordance with, the internal laws of the State of New York without regard to the choice of law principles thereof. Each of the parties hereto irrevocably submits to the exclusive jurisdiction of the courts of the State of New York located in New York County and the United States District Court for the Southern District of New York for the purpose of any suit, action, proceeding or judgment relating to or arising out of this Agreement and the transactions contemplated hereby. Service of process in connection with any such suit, action or proceeding may be served on each party hereto anywhere in the world by the same

methods as are specified for the giving of notices under this Agreement. Each of the parties hereto irrevocably consents to the jurisdiction of any such court in any such suit, action or proceeding and to the laying of venue in such court. Each party hereto irrevocably waives any objection to the laying of venue of any such suit, action or proceeding brought in such courts and irrevocably waives any claim that any such suit, action or proceeding brought in any such court has been brought in an inconvenient forum. **EACH OF THE PARTIES HERETO WAIVES ANY RIGHT TO REQUEST A TRIAL BY JURY IN ANY LITIGATION WITH RESPECT TO THIS AGREEMENT AND REPRESENTS THAT COUNSEL HAS BEEN CONSULTED SPECIFICALLY AS TO THIS WAIVER.**

*[Signature Page Follows]*



If the foregoing accurately reflects our agreement, please execute this letter in the space provided below and return a copy to the undersigned. This letter may be executed in counterparts, each of which shall be deemed an original and all of which together shall constitute one and the same instrument.

ITERIS, INC.

By: /S/ JAMES S. MIELE

Name: \_\_\_\_\_

James S. Miele

Title:

CFO

ACCEPTED AND AGREED:

Special Situations Fund III QP, L.P.

Special Situations Fund III, L.P.

Special Situations Cayman Fund, L.P.

Special Situations Private Equity Fund, L.P.

By: /S/ AUSTIN W. MARXE

Authorized Signatory

Schedule 1

Exceptions to the Company's  
Representations and Warranties

The issuance and sale of the Securities will result in a reduction of less than \$0.01 of the following:

- the conversion price of 25% of the outstanding face amount of the convertible debentures issued in May 2004; and
  - the exercise prices of 25% of the warrants to purchase an aggregate of 673,883 shares of Common Stock issued in May 2004.
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**Exhibit A**

<b>Fund</b>	<b>Number of Warrants</b>	<b>Aggregate Exercise Price</b>	<b>New Warrants</b>
Special Situations Fund III QP, L.P.	651,263	\$ 1,048,533.43	128,299
Special Situations Fund III, L.P.	57,087	\$ 335,363.00	11,246
Special Situations Cayman Fund, L.P.	208,300	\$ 335,363.00	41,035
Special Situations Private Equity Fund, L.P.	333,350	\$ 536,693.50	65,670
Total	1,250,000	\$ 2,012,500.00	246,250

**Exhibit B**

**Form of New Warrant**

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THE SECURITIES REPRESENTED HEREBY MAY NOT BE TRANSFERRED UNLESS (I) SUCH SECURITIES HAVE BEEN REGISTERED FOR SALE PURSUANT TO THE SECURITIES ACT OF 1933, AS AMENDED, (II) SUCH SECURITIES MAY BE SOLD PURSUANT TO RULE 144(K), OR (III) THE COMPANY HAS RECEIVED AN OPINION OF COUNSEL REASONABLY SATISFACTORY TO IT THAT SUCH TRANSFER MAY LAWFULLY BE MADE WITHOUT REGISTRATION UNDER THE SECURITIES ACT OF 1933 OR QUALIFICATION UNDER APPLICABLE STATE SECURITIES LAWS.

SUBJECT TO THE PROVISIONS OF SECTION 10 HEREOF, THIS WARRANT SHALL BE VOID AFTER 5:00 P.M. EASTERN TIME ON SEPTEMBER 28, 2011 (THE "EXPIRATION DATE").

**ITERIS, INC.**

**WARRANT TO PURCHASE                      SHARES OF  
COMMON STOCK, PAR VALUE \$0.10 PER SHARE**

For VALUE RECEIVED, ("Warrantholder"), is entitled to purchase, subject to the provisions of this Warrant, from Iteris, Inc., a Delaware corporation ("Company"), at any time not later than 5:00 P.M., Eastern time, on the Expiration Date (as defined above), at an exercise price per share equal to \$3.25 (the exercise price in effect being herein called the "Warrant Price"),                      shares ("Warrant Shares") of the Company's Common Stock, par value \$0.10 per share ("Common Stock"). The number of Warrant Shares purchasable upon exercise of this Warrant and the Warrant Price shall be subject to adjustment from time to time as described herein. This Warrant is being issued pursuant to the terms of a Warrant Exercise Agreement among the Company, the initial Warrantholder and the initial holders of the Company Warrants (as defined below) (the "Warrant Exercise Agreement").

Section 1.            Registration. The Company shall maintain books for the transfer and registration of the Warrant. Upon the initial issuance of this Warrant, the Company shall issue and register the Warrant in the name of the Warrantholder.

Section 2.            Transfers. As provided herein, this Warrant may be transferred only pursuant to a registration statement filed under the Securities Act of 1933, as amended (the "Securities Act"), or an exemption from such registration. Subject to such restrictions, the Company shall transfer this Warrant from time to time upon the books to be maintained by the Company for that purpose, upon surrender hereof for transfer, properly endorsed or accompanied by appropriate instructions for transfer and such other documents as may be reasonably required by the Company, including, if required by the Company, an opinion of counsel to the Warrantholder to the effect that such transfer is exempt from the registration requirements of the Securities Act, to establish that such transfer is being made in accordance with the terms hereof, and a new Warrant shall be issued to the transferee and the surrendered Warrant shall be canceled by the Company.

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Section 3. Exercise of Warrant. Subject to the provisions hereof, the Warrantholder may exercise this Warrant, in whole or in part, at any time prior to its expiration upon surrender of the Warrant, together with delivery of a duly executed Warrant exercise form, in the form attached hereto as Appendix A (the "Exercise Agreement"), and payment by cash, certified check or wire transfer of funds (or, in certain circumstances, by cashless exercise as provided below) of the aggregate Warrant Price for that number of Warrant Shares then being purchased, to the Company during normal business hours on any business day at the Company's principal executive offices (or such other office or agency of the Company as it may designate by notice to the Warrantholder). The Warrant Shares so purchased shall be deemed to be issued to the Warrantholder or the Warrantholder's designee, as the record owner of such shares, as of the close of business on the date on which this Warrant shall have been surrendered (or the date evidence of loss, theft or destruction thereof and security or indemnity satisfactory to the Company has been provided to the Company), the Warrant Price shall have been paid and the completed Exercise Agreement shall have been delivered. Certificates for the Warrant Shares so purchased shall be delivered to the Warrantholder within a reasonable time, not exceeding three (3) business days, after this Warrant shall have been so exercised. The certificates so delivered shall be in such denominations as may be requested by the Warrantholder and shall be registered in the name of the Warrantholder or such other name as shall be designated by the Warrantholder, as specified in the Exercise Agreement. If this Warrant shall have been exercised only in part, then, unless this Warrant has expired, the Company shall, at its expense, at the time of delivery of such certificates, deliver to the Warrantholder a new Warrant representing the right to purchase the number of shares with respect to which this Warrant shall not then have been exercised. As used herein, "business day" means a day, other than a Saturday or Sunday, on which banks in New York City are open for the general transaction of business. Each exercise hereof shall constitute the re-affirmation by the Warrantholder that the representations and warranties contained in the Warrant Exercise Agreement are true and correct in all material respects with respect to the Warrantholder as of the time of such exercise.

Section 4. Compliance with the Securities Act of 1933. Subject to the terms of the Warrant Exercise Agreement, the Company may cause the legend set forth on the first page of this Warrant to be set forth on each Warrant, and a similar legend on any security issued or issuable upon exercise of this Warrant, unless counsel for the Company is of the opinion as to any such security that such legend is unnecessary.

Section 5. Payment of Taxes. The Company will pay any documentary stamp taxes attributable to the initial issuance of Warrant Shares issuable upon the exercise of the Warrant; provided, however, that the Company shall not be required to pay any tax or taxes which may be payable in respect of any transfer involved in the issuance or delivery of any certificates for Warrant Shares in a name other than that of the Warrantholder in respect of which such shares are issued, and in such case, the Company shall not be required to issue or deliver any certificate for Warrant Shares or any Warrant until the person requesting the same has paid to the Company the amount of such tax or has established to the Company's reasonable satisfaction that such tax has been paid. The Warrantholder shall be responsible for income taxes due under federal, state or other law, if any such tax is due.

Section 6. Mutilated or Missing Warrants. In case this Warrant shall be mutilated, lost, stolen, or destroyed, the Company shall issue in exchange and substitution of and upon surrender and cancellation of the mutilated Warrant, or in lieu of and substitution for the Warrant lost, stolen or destroyed, a new Warrant of like tenor and for the purchase of a like number of Warrant Shares, but only upon receipt of evidence reasonably satisfactory to the Company of such loss, theft or destruction of the Warrant, and with respect to a lost, stolen or destroyed Warrant, reasonable indemnity or bond with respect thereto, if requested by the Company.

Section 7. Reservation of Common Stock. The Company hereby represents and warrants that there have been reserved, and the Company shall at all applicable times keep reserved until issued (if necessary) as contemplated by this Section 7, out of the authorized and unissued shares of Common Stock, sufficient shares to provide for the exercise of the rights of purchase represented by this Warrant. The Company agrees that all Warrant Shares issued upon due exercise of the Warrant shall be, at the time of delivery of the certificates for such Warrant Shares, duly authorized, validly issued, fully paid and non-assessable shares of Common Stock of the Company.

Section 8. Adjustments. Subject and pursuant to the provisions of this Section 8, the Warrant Price and number of Warrant Shares subject to this Warrant shall be subject to adjustment from time to time as set forth hereinafter.

(a) If the Company shall, at any time or from time to time while this Warrant is outstanding, pay a dividend or make a distribution on its Common Stock in shares of Common Stock, subdivide its outstanding shares of Common Stock into a greater number of shares or combine its outstanding shares of Common Stock into a smaller number of shares or issue by reclassification of its outstanding shares of Common Stock any shares of its capital stock (including any such reclassification in connection with a consolidation or merger in which the Company is the continuing corporation), then (i) the Warrant Price in effect immediately prior to the date on which such change shall become effective shall be adjusted by multiplying such Warrant Price by a fraction, the numerator of which shall be the number of shares of Common Stock outstanding immediately prior to such change and the denominator of which shall be the number of shares of Common Stock outstanding immediately after giving effect to such change and (ii) the number of Warrant Shares purchasable upon exercise of this Warrant shall be adjusted by multiplying the number of Warrant Shares purchasable upon exercise of this Warrant immediately prior to the date on which such change shall become effective by a fraction, the numerator of which is shall be the Warrant Price in effect immediately prior to the date on which such change shall become effective and the denominator of which shall be the Warrant Price in effect immediately after giving effect to such change, calculated in accordance with clause (i) above. Such adjustments shall be made successively whenever any event listed above shall occur.

(b) If any capital reorganization, reclassification of the capital stock of the Company, consolidation or merger of the Company with another corporation in which the Company is not the survivor, or sale, transfer or other disposition of all or substantially all of the Company's assets to another corporation shall be effected, then, as a condition of such reorganization, reclassification, consolidation, merger, sale, transfer or other disposition, lawful

and adequate provision shall be made whereby each Warrantholder shall thereafter have the right to purchase and receive upon the basis and upon the terms and conditions herein specified and in lieu of the Warrant Shares immediately theretofore issuable upon exercise of the Warrant, such shares of stock, securities or assets as would have been issuable or payable with respect to or in exchange for a number of Warrant Shares equal to the number of Warrant Shares immediately theretofore issuable upon exercise of the Warrant, had such reorganization, reclassification, consolidation, merger, sale, transfer or other disposition not taken place, and in any such case appropriate provision shall be made with respect to the rights and interests of each Warrantholder to the end that the provisions hereof (including, without limitation, provision for adjustment of the Warrant Price) shall thereafter be applicable, as nearly equivalent as may be practicable in relation to any shares of stock, securities or assets thereafter deliverable upon the exercise hereof. The Company shall not effect any such consolidation, merger, sale, transfer or other disposition unless prior to or simultaneously with the consummation thereof the successor corporation (if other than the Company) resulting from such consolidation or merger, or the corporation purchasing or otherwise acquiring such assets or other appropriate corporation or entity shall assume the obligation to deliver to the Warrantholder, at the last address of the Warrantholder appearing on the books of the Company, such shares of stock, securities or assets as, in accordance with the foregoing provisions, the Warrantholder may be entitled to purchase, and the other obligations under this Warrant. The provisions of this paragraph (b) shall similarly apply to successive reorganizations, reclassifications, consolidations, mergers, sales, transfers or other dispositions.

(c) In case the Company shall fix a payment date for the making of a distribution to all holders of Common Stock (including any such distribution made in connection with a consolidation or merger in which the Company is the continuing corporation) of evidences of indebtedness or assets (other than cash dividends or cash distributions payable out of consolidated earnings or earned surplus or dividends or distributions referred to in Section 8(a)), or subscription rights or warrants, the Warrant Price to be in effect after such payment date shall be determined by multiplying the Warrant Price in effect immediately prior to such payment date by a fraction, the numerator of which shall be the total number of shares of Common Stock outstanding multiplied by the Market Price (as defined below) per share of Common Stock immediately prior to such payment date, less the fair market value (as determined by the Company's Board of Directors in good faith) of said assets or evidences of indebtedness so distributed, or of such subscription rights or warrants, and the denominator of which shall be the total number of shares of Common Stock outstanding multiplied by such Market Price per share of Common Stock immediately prior to such payment date. "Market Price" as of a particular date (the "Valuation Date") shall mean the following: (i) if the Common Stock is then listed on a national stock exchange, the closing sale price of one share of Common Stock on such exchange on the last trading day prior to the Valuation Date; (ii) if the Common Stock is then quoted on, the National Association of Securities Dealers, Inc. OTC Bulletin Board (the "Bulletin Board"), the Pink Sheets, LLC (the "Pink Sheets") or such similar quotation system or association, the closing sale price of one share of Common Stock on the Bulletin Board, the Pink Sheets or such other quotation system or association on the last trading day prior to the Valuation Date or, if no such closing sale price is available, the average of the high bid and the low asked price quoted thereon on the last trading day prior to the Valuation Date; or (iii) if the Common Stock is not then listed on a national stock exchange or quoted on such other quotation system or association,



the fair market value of one share of Common Stock as of the Valuation Date, as determined in good faith by the Board of Directors of the Company and the Warrantholder. If the Common Stock is not then listed on a national securities exchange, the Bulletin Board, the Pink Sheets or such other quotation system or association, the Board of Directors of the Company shall respond promptly, in writing, to an inquiry by the Warrantholder prior to the exercise hereunder as to the fair market value of a share of Common Stock as determined by the Board of Directors of the Company. In the event that the Board of Directors of the Company and the Warrantholder are unable to agree upon the fair market value in respect of clause (iii) of this paragraph, the Company and the Warrantholder shall jointly select an appraiser, who is experienced in such matters. The decision of such appraiser shall be final and conclusive, and the cost of such appraiser shall be borne equally by the Company and the Warrantholder. Such adjustment shall be made successively whenever such a payment date is fixed.

(d) An adjustment to the Warrant Price shall become effective immediately after the payment date in the case of each dividend or distribution and immediately after the effective date of each other event which requires an adjustment.

(e) In the event that, as a result of an adjustment made pursuant to this Section 8, the Warrantholder shall become entitled to receive any shares of capital stock of the Company other than shares of Common Stock, the number of such other shares so receivable upon exercise of this Warrant shall be subject thereafter to adjustment from time to time in a manner and on terms as nearly equivalent as practicable to the provisions with respect to the Warrant Shares contained in this Warrant.

(f) Except as provided in subsection (g) hereof, if and whenever the Company shall issue or sell, or is, in accordance with any of subsections (f)(l) through (f)(7) hereof, deemed to have issued or sold, any Additional Shares of Common Stock for no consideration or for a consideration per share less than the Warrant Price in effect immediately prior to the time of such issue or sale, then and in each such case (a "Trigger Issuance") the then-existing Warrant Price, shall be reduced, as of the close of business on the effective date of the Trigger Issuance, to a price determined as follows:

$$\text{Adjusted Warrant Price} = \frac{(A \times B) + D}{A + C}$$

where

"A" equals the number of shares of Common Stock outstanding, including Additional Shares of Common Stock (as defined below) deemed to be issued hereunder, immediately preceding such Trigger Issuance;

"B" equals the Warrant Price in effect immediately preceding such Trigger Issuance;

"C" equals the number of Additional Shares of Common Stock issued or deemed issued hereunder as a result of the Trigger Issuance; and

“D” equals the aggregate consideration, if any, received or deemed to be received by the Company upon such Trigger Issuance;

provided, however, that in no event shall the Warrant Price after giving effect to such Trigger Issuance be greater than the Warrant Price in effect prior to such Trigger Issuance.

For purposes of this subsection (f), “Additional Shares of Common Stock” shall mean all shares of Common Stock issued by the Company or deemed to be issued pursuant to this subsection (f), other than Excluded Issuances (as defined in subsection (g) hereof).

For purposes of this subsection (f), the following subsections (f)(1) to (f)(7) shall also be applicable:

(f)(1) Issuance of Rights or Options. In case at any time the Company shall in any manner grant (directly and not by assumption in a merger or otherwise) any warrants or other rights to subscribe for or to purchase, or any options for the purchase of, Common Stock or any stock or security convertible into or exchangeable for Common Stock (such warrants, rights or options being called “Options” and such convertible or exchangeable stock or securities being called “Convertible Securities”) whether or not such Options or the right to convert or exchange any such Convertible Securities are immediately exercisable, and the price per share for which Common Stock is issuable upon the exercise of such Options or upon the conversion or exchange of such Convertible Securities (determined by dividing (i) the sum (which sum shall constitute the applicable consideration) of (x) the total amount, if any, received or receivable by the Company as consideration for the granting of such Options, plus (y) the aggregate amount of additional consideration payable to the Company upon the exercise of all such Options, plus (z), in the case of such Options which relate to Convertible Securities, the aggregate amount of additional consideration, if any, payable upon the issue or sale of such Convertible Securities and upon the conversion or exchange thereof, by (ii) the total maximum number of shares of Common Stock issuable upon the exercise of such Options or upon the conversion or exchange of all such Convertible Securities issuable upon the exercise of such Options) shall be less than the Warrant Price in effect immediately prior to the time of the granting of such Options, then the total number of shares of Common Stock issuable upon the exercise of such Options or upon conversion or exchange of the total amount of such Convertible Securities issuable upon the exercise of such Options shall be deemed to have been issued for such price per share as of the date of granting of such Options or the issuance of such Convertible Securities and thereafter shall be deemed to be outstanding for purposes of adjusting the Warrant Price. Except as otherwise provided in subsection 8(f)(3), no adjustment of the Warrant Price shall be made upon the actual issue of such Common Stock or of such Convertible Securities upon exercise of such Options or upon the actual issue of such Common Stock upon conversion or exchange of such Convertible Securities.

(f)(2) Issuance of Convertible Securities. In case the Company shall in any manner issue (directly and not by assumption in a merger or otherwise) or sell any Convertible Securities, whether or not the rights to exchange or convert any such Convertible Securities are immediately exercisable, and the price per share for which Common Stock is issuable upon such conversion or exchange (determined by dividing (i) the sum (which sum shall constitute the applicable consideration) of (x) the total amount received or receivable by the Company as consideration for the issue or sale of such Convertible Securities, plus (y) the aggregate amount of additional consideration, if any, payable to the Company upon the conversion or exchange thereof, by (ii) the total number of shares of Common Stock issuable upon the conversion or exchange of all such Convertible Securities) shall be less than the Warrant Price in effect immediately prior to the time of such issue or sale, then the total maximum number of shares of Common Stock issuable upon conversion or exchange of all such Convertible Securities shall be deemed to have been issued for such price per share as of the date of the issue or sale of such Convertible Securities and thereafter shall be deemed to be outstanding for purposes of adjusting the Warrant Price, provided that (a) except as otherwise provided in subsection 8(f)(3), no adjustment of the Warrant Price shall be made upon the actual issuance of such Common Stock upon conversion or exchange of such Convertible Securities and (b) no further adjustment of the Warrant Price shall be made by reason of the issue or sale of Convertible Securities upon exercise of any Options to purchase any such Convertible Securities for which adjustments of the Warrant Price have been made pursuant to the other provisions of subsection 8(f).

(f)(3) Change in Option Price or Conversion Rate. Upon the happening of any of the following events, namely, if the purchase price provided for in any Option referred to in subsection 8(f)(1) hereof, the additional consideration, if any, payable upon the conversion or exchange of any Convertible Securities referred to in subsections 8(f)(1) or 8(f)(2), or the rate at which Convertible Securities referred to in subsections 8(f)(1) or 8(f)(2) are convertible into or exchangeable for Common Stock shall change at any time (including, but not limited to, changes under or by reason of provisions designed to protect against dilution), the Warrant Price in effect at the time of such event shall forthwith be readjusted to the Warrant Price which would have been in effect at such time had such Options or Convertible Securities still outstanding provided for such changed purchase price, additional consideration or conversion rate, as the case may be, at the time initially granted, issued or sold. On the termination of any Option for which any adjustment was made pursuant to this subsection 8(f) or any right to convert or exchange Convertible Securities for which any adjustment was made pursuant to this subsection 8(f) (including without limitation upon the redemption or purchase for consideration of such Convertible Securities by the Company), the Warrant Price then in effect hereunder shall forthwith be changed to the Warrant Price which would have been in effect at the time of such termination had such Option or Convertible Securities, to the extent outstanding immediately prior to such termination, never been issued.

(f)(4) Stock Dividends. Subject to the provisions of this Section 8(f), in case the Company shall declare or pay a dividend or make any other distribution upon any stock of the Company (other than the Common Stock) payable in Common Stock, Options or Convertible Securities, then any Common Stock, Options or Convertible Securities, as the case may be, issuable in payment of such dividend or distribution shall be deemed to have been issued or sold without consideration.

(f)(5) Consideration for Stock. In case any shares of Common Stock, Options or Convertible Securities shall be issued or sold for cash, the consideration received therefor shall be deemed to be the net amount received by the Company therefor, after deduction therefrom of any expenses incurred or any underwriting commissions or concessions paid or allowed by the Company in connection therewith. In case any shares of Common Stock, Options or Convertible Securities shall be issued or sold for a consideration other than cash, the amount of the consideration other than cash received by the Company shall be deemed to be the fair value of such consideration as determined in good faith by the Board of Directors of the Company, after deduction of any expenses incurred or any underwriting commissions or concessions paid or allowed by the Company in connection therewith. In case any Options shall be issued in connection with the issue and sale of other securities of the Company, together comprising one integral transaction in which no specific consideration is allocated to such Options by the parties thereto, such Options shall be deemed to have been issued for such consideration as determined in good faith by the Board of Directors of the Company. If Common Stock, Options or Convertible Securities shall be issued or sold by the Company and, in connection therewith, other Options or Convertible Securities (the "Additional Rights") are issued, then the consideration received or deemed to be received by the Company shall be reduced by the fair market value of the Additional Rights (as determined using the Black-Scholes option pricing model or another method mutually agreed to by the Company and the Warrantholder). The Board of Directors of the Company shall respond promptly, in writing, to an inquiry by the Warrantholder as to the fair market value of the Additional Rights. In the event that the Board of Directors of the Company and the Warrantholder are unable to agree upon the fair market value of the Additional Rights, the Company and the Warrantholder shall jointly select an appraiser, who is experienced in such matters. The decision of such appraiser shall be final and conclusive, and the cost of such appraiser shall be borne evenly by the Company and the Warrantholder.

(f)(6) Record Date. In case the Company shall take a record of the holders of its Common Stock for the purpose of entitling them (i) to receive a dividend or other distribution payable in Common Stock, Options or Convertible Securities or (ii) to subscribe for or purchase Common Stock, Options or Convertible Securities, then such record date shall be deemed to be the date of the issue or sale of the shares of Common Stock deemed to have been issued or sold upon the

declaration of such dividend or the making of such other distribution or the date of the granting of such right of subscription or purchase, as the case may be.

(f)(7) Treasury Shares. The number of shares of Common Stock outstanding at any given time shall not include shares owned or held by or for the account of the Company or any of its wholly-owned subsidiaries, and the disposition of any such shares (other than the cancellation or retirement thereof) shall be considered an issue or sale of Common Stock for the purpose of this subsection (f).

(g) Anything herein to the contrary notwithstanding, the Company shall not be required to make any adjustment of the Warrant Price in the case of the issuance of (A) capital stock, Options or Convertible Securities issued to directors, officers, employees or consultants of the Company in connection with their service as directors of the Company, their employment by the Company or their retention as consultants by the Company pursuant to an equity compensation program or other agreement or arrangement approved by the Board of Directors of the Company or the compensation committee of the Board of Directors of the Company, (B) shares of Common Stock issued upon the conversion or exercise of Options or Convertible Securities issued prior to the date hereof, provided such securities are not amended after the date hereof to increase the number of shares of Common Stock issuable thereunder or to lower the exercise or conversion price thereof, and (C) shares of Common Stock issued or issuable by reason of a dividend, stock split or other distribution on shares of Common Stock (but only to the extent that such a dividend, split or distribution results in an adjustment in the Warrant Price pursuant to the other provisions of this Warrant) (collectively, "Excluded Issuances").

(h) Upon any adjustment to the Warrant Price pursuant to Section 8(f) above, the number of Warrant Shares purchasable hereunder shall be adjusted by multiplying such number by a fraction, the numerator of which shall be the Warrant Price in effect immediately prior to such adjustment and the denominator of which shall be the Warrant Price in effect immediately thereafter.

Section 9. Fractional Interest. The Company shall not be required to issue fractions of Warrant Shares upon the exercise of this Warrant. If any fractional share of Common Stock would, except for the provisions of the first sentence of this Section 9, be deliverable upon such exercise, the Company, in lieu of delivering such fractional share, shall pay to the exercising Warrantholder an amount in cash equal to the Market Price of such fractional share of Common Stock on the date of exercise.

Section 10. Extension of Expiration Date. If the Company fails to cause any Registration Statement covering Registrable Securities (unless otherwise defined herein, capitalized terms are as defined in the Registration Rights Agreement relating to the Warrant Shares (the "Registration Rights Agreement")) to be declared effective prior to the applicable dates set forth therein, or if any of the events specified in Section 2(c)(ii) of the Registration Rights Agreement occurs, and the Blackout Period (whether alone, or in combination with any other Blackout Period) continues for more than 60 days in any 12 month period, or for more than

a total of 90 days, then the Expiration Date of this Warrant shall be extended one day for each day beyond the 60-day or 90-day limits, as the case may be, that the Blackout Period continues.

Section 11. Benefits. Nothing in this Warrant shall be construed to give any person, firm or corporation (other than the Company and the Warrantholder) any legal or equitable right, remedy or claim, it being agreed that this Warrant shall be for the sole and exclusive benefit of the Company and the Warrantholder.

Section 12. Notices to Warrantholder. Upon the happening of any event requiring an adjustment of the Warrant Price, the Company shall promptly give written notice thereof to the Warrantholder at the address appearing in the records of the Company, stating the adjusted Warrant Price and the adjusted number of Warrant Shares resulting from such event and setting forth in reasonable detail the method of calculation and the facts upon which such calculation is based. Failure to give such notice to the Warrantholder or any defect therein shall not affect the legality or validity of the subject adjustment.

Section 13. Identity of Transfer Agent. The Transfer Agent for the Common Stock is U.S. Stock Transfer Corporation. Upon the appointment of any subsequent transfer agent for the Common Stock or other shares of the Company's capital stock issuable upon the exercise of the rights of purchase represented by the Warrant, the Company will mail to the Warrantholder a statement setting forth the name and address of such transfer agent.

Section 14. Notices. Unless otherwise provided, any notice required or permitted under this Warrant shall be given in writing and shall be deemed effectively given as hereinafter described (i) if given by personal delivery, then such notice shall be deemed given upon such delivery, (ii) if given by telex or facsimile, then such notice shall be deemed given upon receipt of confirmation of complete transmittal, (iii) if given by mail, then such notice shall be deemed given upon the earlier of (A) receipt of such notice by the recipient or (B) three days after such notice is deposited in first class mail, postage prepaid, and (iv) if given by an internationally recognized overnight air courier, then such notice shall be deemed given one business day after delivery to such carrier. All notices shall be addressed as follows: if to the Warrantholder, at its address as set forth in the Company's books and records and, if to the Company, at the address as follows, or at such other address as the Warrantholder or the Company may designate by ten days' advance written notice to the other:

If to the Company:

Iteris, Inc.  
1515 South Manchester Avenue  
Anaheim, California 92802  
Attention: Jack Johnson  
Fax: (714) 780-7857

Section 15. Registration Rights. The initial Warrantholder is entitled to the benefit of certain registration rights with respect to the shares of Common Stock issuable upon the exercise

of this Warrant as provided in the Registration Rights Agreement, and any subsequent Warrantholder may be entitled to such rights.

Section 16. Successors. All the covenants and provisions hereof by or for the benefit of the Warrantholder shall bind and inure to the benefit of its respective successors and assigns hereunder.

Section 17. Governing Law; Consent to Jurisdiction; Waiver of Jury Trial. This Warrant shall be governed by, and construed in accordance with, the internal laws of the State of New York, without reference to the choice of law provisions thereof. The Company and, by accepting this Warrant, the Warrantholder, each irrevocably submits to the exclusive jurisdiction of the courts of the State of New York located in New York County and the United States District Court for the Southern District of New York for the purpose of any suit, action, proceeding or judgment relating to or arising out of this Warrant and the transactions contemplated hereby. Service of process in connection with any such suit, action or proceeding may be served on each party hereto anywhere in the world by the same methods as are specified for the giving of notices under this Warrant. The Company and, by accepting this Warrant, the Warrantholder, each irrevocably consents to the jurisdiction of any such court in any such suit, action or proceeding and to the laying of venue in such court. The Company and, by accepting this Warrant, the Warrantholder, each irrevocably waives any objection to the laying of venue of any such suit, action or proceeding brought in such courts and irrevocably waives any claim that any such suit, action or proceeding brought in any such court has been brought in an inconvenient forum. **EACH OF THE COMPANY AND, BY ITS ACCEPTANCE HEREOF, THE WARRANTHOLDER HEREBY WAIVES ANY RIGHT TO REQUEST A TRIAL BY JURY IN ANY LITIGATION WITH RESPECT TO THIS WARRANT AND REPRESENTS THAT COUNSEL HAS BEEN CONSULTED SPECIFICALLY AS TO THIS WAIVER.**

Section 18. Call Provision. Notwithstanding any other provision contained in this Warrant to the contrary, in the event that the closing bid price per share of Common Stock as traded on the American Stock Exchange (or such other exchange or stock market on which the Common Stock may then be listed or quoted) equals or exceeds \$6.50 (appropriately adjusted for any stock split, reverse stock split, stock dividend or other reclassification or combination of the Common Stock occurring after the date hereof) for any twenty (20) consecutive trading days commencing after the Registration Statement (as defined in the Registration Rights Agreement) has been declared effective, the Company, upon thirty (30) days prior written notice (the "Notice Period") given to the Warrantholder within one (1) business day immediately following the end of such twenty (20) trading day period, may call this Warrant, in whole but not in part, at a redemption price equal to \$0.01 per share of Common Stock then purchasable pursuant to this Warrant; provided that (i) the Company simultaneously calls all Company Warrants (as defined below) on the same terms, (ii) all of the shares of Common Stock issuable hereunder either (A) are registered pursuant to an effective Registration Statement (as defined in the Registration Rights Agreement) which is not suspended and for which no stop order is in effect, and pursuant to which the Warrantholder is able to sell such shares of Common Stock at all times during the Notice Period or (B) no longer constitute Registrable Securities (as defined in the Registration Rights Agreement) and (iii) this Warrant is fully exercisable for the full amount of Warrant

Shares covered hereby. Notwithstanding any such notice by the Company, the Warrantholder shall have the right to exercise this Warrant prior to the end of the Notice Period.

Section 19. Cashless Exercise. Notwithstanding any other provision contained herein to the contrary, from and after the first anniversary of the Closing Date (as defined in the Warrant Exercise Agreement) and so long as the Company is required under the Registration Rights Agreement to have effected and keep effective the registration of the Warrant Shares for resale to the public pursuant to a Registration Statement (as such term is defined in the Registration Rights Agreement), if the Warrant Shares may not be freely sold to the public because such shares are not covered by an effective Registration Statement which is not suspended and for which no stop order is in effect, then during such period in which the Warrant Shares may not be freely sold to the public (but excluding the period of any Allowed Delay (as defined in the Registration Rights Agreement)), the Warrantholder may elect to receive, without the payment by the Warrantholder of the aggregate Warrant Price in respect of the shares of Common Stock to be acquired, shares of Common Stock of equal value to the value of this Warrant, or any specified portion hereof, by the surrender of this Warrant (or such portion of this Warrant being so exercised) together with a Net Issue Election Notice, in the form annexed hereto as Appendix B, duly executed, to the Company. Thereupon, the Company shall issue to the Warrantholder such number of fully paid, validly issued and nonassessable shares of Common Stock as is computed using the following formula:

$$X = \frac{Y(A - B)}{A}$$

where

X = the number of shares of Common Stock to which the Warrantholder is entitled upon such cashless exercise;

Y = the total number of shares of Common Stock covered by this Warrant for which the Warrantholder has surrendered purchase rights at such time for cashless exercise (including both shares to be issued to the Warrantholder and shares as to which the purchase rights are to be canceled as payment therefor);

A = the "Market Price" of one share of Common Stock as of the date the net issue election is made; and

B = the Warrant Price in effect under this Warrant at the time the net issue election is made.

Section 20. No Rights as Stockholder. Prior to the exercise of this Warrant, the Warrantholder shall not have or exercise any rights as a stockholder of the Company by virtue of its ownership of this Warrant.

Section 21. Amendment; Waiver. This Warrant is one of a series of Warrants of like tenor issued by the Company pursuant to the Warrant Exercise Agreement and initially covering



an aggregate of 246,250 shares of Common Stock (collectively, the “Company Warrants”). Any term of this Warrant may be amended or waived (including the adjustment provisions included in Section 8 of this Warrant) upon the written consent of the Company and the holders of Company Warrants representing at least 50% of the number of shares of Common Stock then subject to all outstanding Company Warrants (the “Majority Holders”); provided, that (x) any such amendment or waiver must apply to all Company Warrants; and (y) the number of Warrant Shares subject to this Warrant, the Warrant Price and the Expiration Date may not be amended, and the right to exercise this Warrant may not be altered or waived, without the written consent of the Warrantholder.

Section 22. Section Headings. The section headings in this Warrant are for the convenience of the Company and the Warrantholder and in no way alter, modify, amend, limit or restrict the provisions hereof.

*[Signature Page Follows]*

IN WITNESS WHEREOF, the Company has caused this Warrant to be duly executed, as of the 28th day of September, 2006.

ITERIS, INC.

By: \_\_\_\_\_  
Name: James S. Miele  
Title: Chief Financial Officer

APPENDIX A  
ITERIS, INC.  
WARRANT EXERCISE FORM

To Iteris, Inc.:

The undersigned hereby irrevocably elects to exercise the right of purchase represented by the within Warrant ("Warrant") for, and to purchase thereunder by the payment of the Warrant Price and surrender of the Warrant, \_\_\_\_\_ shares of Common Stock ("Warrant Shares") provided for therein, and requests that certificates for the Warrant Shares be issued as follows:

\_\_\_\_\_  
Name

\_\_\_\_\_  
Address

\_\_\_\_\_  
Federal Tax ID or Social Security No.

and delivered by:      ☐ certified mail to the above address, or  
(check one)            ☐ electronically (provide DWAC Instructions: \_\_\_\_\_), or  
                                 ☐ other (specify): \_\_\_\_\_.

and, if the number of Warrant Shares shall not be all the Warrant Shares purchasable upon exercise of the Warrant, that a new Warrant for the balance of the Warrant Shares purchasable upon exercise of this Warrant be registered in the name of the undersigned Warrantholder or the undersigned's Assignee as below indicated and delivered to the address stated below.

Dated: \_\_\_\_\_, \_\_\_\_\_

Note: The signature must correspond with the name of the Warrantholder as written on the first page of the Warrant in every particular, without alteration or enlargement or any change whatever, unless the Warrant has been assigned.

Signature: \_\_\_\_\_

\_\_\_\_\_  
Name (please print)

\_\_\_\_\_  
Address

\_\_\_\_\_  
Federal Identification or  
Social Security No.

Assignee:  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

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APPENDIX B  
ITERIS, INC.  
NET ISSUE ELECTION NOTICE

To: Iteris, Inc.

Date: [ ]

The undersigned hereby elects under Section 19 of this Warrant to surrender the right to purchase [ ] shares of Common Stock pursuant to this Warrant and hereby requests the issuance of [ ] shares of Common Stock. The certificate(s) for the shares issuable upon such net issue election shall be issued in the name of the undersigned or as otherwise indicated below.

Signature

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Name for Registration

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Mailing Address

\_\_\_\_\_

**Exhibit C**

**Registration Rights Agreement**

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**REGISTRATION RIGHTS AGREEMENT**

This Registration Rights Agreement (the “Agreement”) is made and entered into as of this 28<sup>th</sup> day of September, 2006 by and among Iteris, Inc., a Delaware corporation (the “Company”), and the “Funds” named in that certain Warrant Exercise Agreement by and among the Company and the Funds (the “Warrant Exercise Agreement”).

The parties hereby agree as follows:

1. Certain Definitions.

As used in this Agreement, the following terms shall have the following meanings:

“Affiliate” means, with respect to any person, any other person which directly or indirectly controls, is controlled by, or is under common control with, such person.

“Business Day” means a day, other than a Saturday or Sunday, on which banks in New York City are open for the general transaction of business.

“Common Stock” shall mean the Company’s common stock, par value \$0.10 per share, and any securities into which such shares may hereinafter be reclassified.

“Investors” shall mean the Funds identified in the Warrant Exercise Agreement and any Affiliate or permitted transferee of any Investor who is a subsequent holder of any Warrants or Registrable Securities.

“Prospectus” shall mean (i) the prospectus included in any Registration Statement, as amended or supplemented by any prospectus supplement, with respect to the terms of the offering of any portion of the Registrable Securities covered by such Registration Statement and by all other amendments and supplements to the prospectus, including post-effective amendments and all material incorporated by reference in such prospectus, and (ii) any “free writing prospectus” as defined in Rule 405 under the 1933 Act.

“Register,” “registered” and “registration” refer to a registration made by preparing and filing a Registration Statement or similar document in compliance with the 1933 Act (as defined below), and the declaration or ordering of effectiveness of such Registration Statement or document.

“Registrable Securities” shall mean (i) the Warrant Shares and (ii) any other securities issued or issuable with respect to or in exchange for Registrable Securities; provided, that, a security shall cease to be a Registrable Security upon (A) sale pursuant to a Registration Statement or Rule 144 under the 1933 Act, or (B) such security becoming eligible for sale by the Investors pursuant to Rule 144(k).

“Registration Statement” shall mean any registration statement of the Company filed under the 1933 Act that covers the resale of any of the Registrable Securities pursuant to the provisions of this Agreement, amendments and supplements to such Registration Statement, including post-effective amendments, all exhibits and all material incorporated by reference in such Registration Statement.

“Required Investors” means the Investors holding a majority of the Registrable Securities.

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“SEC” means the U.S. Securities and Exchange Commission.

“1933 Act” means the Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder.

“1934 Act” means the Securities Exchange Act of 1934, as amended, and the rules and regulations promulgated thereunder.

“Warrants” means, the warrants to purchase shares of Common Stock issued to the Investors pursuant to the Warrant Exercise Agreement.

“Warrant Shares” means the shares of Common Stock issuable upon the exercise of the Warrants.

2. Registration.

(a) Registration Statements.

(i) Promptly following the closing of the transactions contemplated by the Warrant Exercise Agreement (the “Closing Date”) but no later than sixty (60) days after the Closing Date (the “Filing Deadline”), the Company shall prepare and file with the SEC one Registration Statement on Form S-3 (or, if Form S-3 is not then available to the Company, on such form of registration statement as is then available to effect a registration for resale of the Registrable Securities, subject to the Required Investors’ consent, which shall not be unreasonably withheld), covering the resale of the Registrable Securities in an amount at least equal to the Warrant Shares set forth on the face of the Warrants. Subject to any SEC comments, such Registration Statement shall include the plan of distribution attached hereto as Exhibit A. Such Registration Statement also shall cover, to the extent allowable under the 1933 Act and the rules promulgated thereunder (including Rule 416), such indeterminate number of additional shares of Common Stock resulting from stock splits, stock dividends or similar transactions with respect to the Registrable Securities. Such Registration Statement shall not include any shares of Common Stock or other securities for the account of any other holder without the prior written consent of the Required Investors. The Registration Statement (and each amendment or supplement thereto, and each request for acceleration of effectiveness thereof) shall be provided in accordance with Section 3(c) to the Investors and their counsel prior to its filing or other submission. If a Registration Statement covering the Registrable Securities is not filed with the SEC on or prior to the Filing Deadline, the Company will make pro rata payments to each Investor, as liquidated damages and not as a penalty, in an amount equal to 1.0% of the aggregate exercise price of the Warrants acquired by such Investor for each 30-day period or pro rata for any portion thereof following the Filing Deadline for which no Registration Statement is filed with respect to the Registrable Securities. Such payments shall constitute the Investors’ exclusive monetary remedy for such events, but shall not affect the right of the Investors to seek injunctive relief. Such payments shall be made to each Investor in cash.

(ii) Additional Registrable Securities. Upon the written demand of any Investor and upon any change in the Warrant Price (as defined in the Warrant) such that additional shares of Common Stock become issuable upon the exercise of the Warrants (the “Additional Shares”), the Company shall prepare and file with the SEC one or more Registration Statements on Form S-3 or amend the Registration Statement filed pursuant to clause (i) above, if such Registration Statement has not previously been declared effective (or, if Form S-3 is not

then available to the Company, on such form of registration statement as is then available to effect a registration for resale of the Additional Shares, subject to the Required Investors' consent, which shall not be unreasonably withheld) covering the resale of the Additional Shares, but only to the extent the Additional Shares are not at the time covered by an effective Registration Statement. Subject to any SEC comments, such Registration Statement shall include the plan of distribution attached hereto as Exhibit A. Such Registration Statement also shall cover, to the extent allowable under the 1933 Act and the rules promulgated thereunder (including Rule 416), such indeterminate number of additional shares of Common Stock resulting from stock splits, stock dividends or similar transactions with respect to the Additional Shares. Such Registration Statement shall not include any shares of Common Stock or other securities for the account of any other holder without the prior written consent of the Required Investors. The Registration Statement (and each amendment or supplement thereto, and each request for acceleration of effectiveness thereof) shall be provided in accordance with Section 3(c) to the Investors and their counsel prior to its filing or other submission. If a Registration Statement covering the Additional Shares is required to be filed under this Section 2(a)(ii) and is not filed with the SEC within thirty (30) days of the request of any Investor or upon the occurrence of any of the events specified in this Section 2(a)(ii), the Company will make pro rata payments to each Investor, as liquidated damages and not as a penalty, in an amount equal to 1.0% of the aggregate exercise price of the Warrants acquired by such Investor for each 30-day period or pro rata for any portion thereof following the date by which such Registration Statement should have been filed for which no Registration Statement is filed with respect to the Additional Shares. Such payments shall constitute the Investors' exclusive monetary remedy for such events, but shall not affect the right of the Investors to seek injunctive relief. Such payments shall be made to each Investor in cash.

(b) Expenses. The Company will pay all expenses associated with each registration, including filing and printing fees, the Company's counsel and accounting fees and expenses, costs associated with clearing the Registrable Securities for sale under applicable state securities laws, listing fees, fees and expenses of one counsel to the Investors, not to exceed \$5,000, and the Investors' reasonable out-of-pocket expenses in connection with the registration, but excluding discounts, commissions, fees of underwriters, selling brokers, dealer managers or similar securities industry professionals with respect to the Registrable Securities being sold.

(c) Effectiveness.

(i) The Company shall use commercially reasonable efforts to have the Registration Statement declared effective as soon as practicable. The Company shall notify the Investors by facsimile or e-mail as promptly as practicable, and in any event, within twenty-four (24) hours, after any Registration Statement is declared effective and shall provide the Investors promptly thereafter with copies of any related Prospectus to be used in connection with the sale or other disposition of the securities covered thereby. If (A)(x) a Registration Statement covering the Registrable Securities is not declared effective by the SEC on or prior to the earlier of (i) five (5) Business Days after the SEC shall have informed the Company that no review of the Registration Statement will be made or that the SEC has no further comments on the Registration Statement or (ii) the 120<sup>th</sup> day after the Closing Date (150 days after the Closing Date in the event that the Registration Statement is reviewed by the SEC) or (y) a Registration Statement covering Additional Shares is not declared effective by the SEC within 60 days (90



days in the event that the Registration Statement is reviewed by the SEC) following the time such Registration Statement was required to be filed pursuant to Section 2(a)(ii), or (B) after a Registration Statement has been declared effective by the SEC, sales cannot be made pursuant to such Registration Statement for any reason (including without limitation by reason of a stop order, or the Company's failure to update the Registration Statement), but excluding the inability of any Investor to sell the Registrable Securities covered thereby due to market conditions and except as excused pursuant to subparagraph (ii) below, then the Company will make pro rata payments to each Investor, as liquidated damages and not as a penalty, in an amount equal to 1.0% of the aggregate exercise price of the Warrants acquired by such Investor for each 30-day period or pro rata for any portion thereof following the date by which such Registration Statement should have been effective (the "Blackout Period"). Such payments shall constitute the Investors' exclusive monetary remedy for such events, but shall not affect the right of the Investors to seek injunctive relief. The amounts payable as liquidated damages pursuant to this paragraph shall be paid monthly within three (3) Business Days of the last day of each month following the commencement of the Blackout Period until the termination of the Blackout Period. Such payments shall be made to each Investor in cash.

(ii) For not more than twenty (20) consecutive days or for a total of not more than forty-five (45) days in any twelve (12) month period, the Company may delay the disclosure of material non-public information concerning the Company, by suspending the use of any Prospectus included in any registration contemplated by this Section containing such information, the disclosure of which at the time is not, in the good faith opinion of the Company, in the best interests of the Company (an "Allowed Delay"); provided, that the Company shall promptly (a) notify the Investors in writing of the existence of (but in no event, without the prior written consent of an Investor, shall the Company disclose to such Investor any of the facts or circumstances regarding) material non-public information giving rise to an Allowed Delay, (b) advise the Investors in writing to cease all sales under the Registration Statement until the end of the Allowed Delay and (c) use commercially reasonable efforts to resolve the circumstances leading to the imposition of an Allowed Delay as promptly as practicable.

(d) Limitation on Liquidated Damages. Notwithstanding any other provision of this Agreement, in no event shall the Company be liable for liquidated damages pursuant to this Agreement in excess of an aggregate of 12% of the aggregate exercise price of the Warrants.

3. Company Obligations. The Company will use commercially reasonable efforts to effect the registration of the Registrable Securities in accordance with the terms hereof, and pursuant thereto the Company will, as expeditiously as possible:

(a) use commercially reasonable efforts to cause such Registration Statement to become effective and to remain continuously effective for a period that will terminate upon the earlier of (i) the date on which all Registrable Securities covered by such Registration Statement as amended from time to time, have been sold, and (ii) the date on which all Registrable Securities covered by such Registration Statement may be sold pursuant to Rule 144(k) (such period, the "Effectiveness Period") and advise the Investors in writing prior to terminating the effectiveness of the Registration Statement following the conclusion of the Effectiveness Period;

(b) prepare and file with the SEC such amendments and post-effective amendments to the Registration Statement and the Prospectus as may be necessary to keep the Registration Statement effective for the Effectiveness Period and to comply with the provisions of the 1933 Act and the 1934 Act with respect to the distribution of all of the Registrable Securities covered thereby;

(c) provide copies to and permit counsel designated by the Investors to review each Registration Statement and all amendments and supplements thereto no fewer than seven (7) days prior to their filing with the SEC and not file any document to which such counsel reasonably objects;

(d) furnish to the Investors and their legal counsel by e-mail, facsimile or other equivalent method (i) promptly after the same is prepared and publicly distributed, filed with the SEC, or received by the Company (but not later than two (2) Business Days after the filing date, receipt date or sending date, as the case may be) one (1) copy of any Registration Statement and any amendment thereto, each preliminary prospectus and Prospectus and each amendment or supplement thereto, and each letter written by or on behalf of the Company to the SEC or the staff of the SEC, and each item of correspondence from the SEC or the staff of the SEC, in each case relating to such Registration Statement (other than any portion of any thereof which contains information for which the Company has sought confidential treatment), and (ii) such number of copies of a Prospectus, including a preliminary prospectus, and all amendments and supplements thereto and such other documents as each Investor may reasonably request in order to facilitate the disposition of the Registrable Securities owned by such Investor that are covered by the related Registration Statement;

(e) use commercially reasonable efforts to (i) prevent the issuance of any stop order or other suspension of effectiveness and, (ii) if such order is issued, obtain the withdrawal of any such order at the earliest possible moment;

(f) prior to any public offering of Registrable Securities, use commercially reasonable efforts to register or qualify or cooperate with the Investors and their counsel in connection with the registration or qualification of such Registrable Securities for offer and sale under the securities or blue sky laws of such jurisdictions requested by the Investors and do any and all other commercially reasonable acts or things necessary or advisable to enable the distribution in such jurisdictions of the Registrable Securities covered by the Registration Statement; provided, however, that the Company shall not be required in connection therewith or as a condition thereto to (i) qualify to do business in any jurisdiction where it would not otherwise be required to qualify but for this Section 3(f), (ii) subject itself to general taxation in any jurisdiction where it would not otherwise be so subject but for this Section 3(f), or (iii) file a general consent to service of process in any such jurisdiction;

(g) use commercially reasonable efforts to cause all Registrable Securities covered by a Registration Statement to be listed on each securities exchange, interdealer quotation system or other market on which similar securities issued by the Company are then listed;

(h) immediately notify the Investors, at any time prior to the end of the Effectiveness Period, upon discovery that, or upon the happening of any event as a result of which, the Prospectus includes an untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading in light of the circumstances then existing, and promptly prepare, file with the SEC and furnish to such holder a supplement to or an amendment of such Prospectus as may be necessary so that such Prospectus shall not include an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading in light of the circumstances then existing; and

(i) otherwise use commercially reasonable efforts to comply with all applicable rules and regulations of the SEC under the 1933 Act and the 1934 Act, including, without limitation, Rule 172 under the 1933 Act, file any final Prospectus, including any supplement or amendment thereof, with the SEC pursuant to Rule 424 under the 1933 Act, promptly inform the Investors in writing if, at any time during the Effectiveness Period, the Company does not satisfy the conditions specified in Rule 172 and, as a result thereof, the Investors are required to deliver a Prospectus in connection with any disposition of Registrable Securities and take such other actions as may be reasonably necessary to facilitate the registration of the Registrable Securities hereunder; and make available to its security holders, as soon as reasonably practicable, but not later than the Availability Date (as defined below), an earnings statement covering a period of at least twelve (12) months, beginning after the effective date of each Registration Statement, which earnings statement shall satisfy the provisions of Section 11(a) of the 1933 Act, including Rule 158 promulgated thereunder (for the purpose of this subsection 3(i), "Availability Date" means the 45th day following the end of the fourth fiscal quarter that includes the effective date of such Registration Statement, except that, if such fourth fiscal quarter is the last quarter of the Company's fiscal year, "Availability Date" means the 90th day after the end of such fourth fiscal quarter).

(j) With a view to making available to the Investors the benefits of Rule 144 (or its successor rule) and any other rule or regulation of the SEC that may at any time permit the Investors to sell the shares of Common Stock to the public without registration, the Company covenants and agrees to: (i) make and keep public information available, as those terms are understood and defined in Rule 144, until the earlier of (A) six months after such date as all of the Registrable Securities may be resold pursuant to Rule 144(k) or any other rule of similar effect or (B) such date as all of the Registrable Securities shall have been resold; (ii) file with the SEC in a timely manner all reports and other documents required of the Company under the 1934 Act; and (iii) furnish to each Investor upon request, as long as such Investor owns any Registrable Securities, (A) a written statement by the Company that it has complied with the reporting requirements of the 1934 Act, (B) a copy of the Company's most recent Annual Report on Form 10-K or Quarterly Report on Form 10-Q, and (C) such other information as may be reasonably requested in order to avail such Investor of any rule or regulation of the SEC that permits the selling of any such Registrable Securities without registration.

4. Due Diligence Review; Information. The Company shall make available, during normal business hours, for inspection and review by the Investors, advisors to and representatives of the Investors (who may or may not be affiliated with the Investors and who are reasonably acceptable to the Company), all financial and other records, all filings with the SEC,

and all other corporate documents and properties of the Company as may be reasonably necessary for the purpose of such review, and cause the Company's officers, directors and employees, within a reasonable time period, to supply all such information reasonably requested by the Investors or any such representative, advisor or underwriter in connection with such Registration Statement (including, without limitation, in response to all questions and other inquiries reasonably made or submitted by any of them), prior to and from time to time after the filing and effectiveness of the Registration Statement for the sole purpose of enabling the Investors and such representatives, advisors and underwriters and their respective accountants and attorneys to conduct initial and ongoing due diligence with respect to the Company and the accuracy of such Registration Statement.

The Company shall not disclose material nonpublic information to the Investors, or to advisors to or representatives of the Investors, unless prior to disclosure of such information the Company identifies such information as being material nonpublic information and provides the Investors, such advisors and representatives with the opportunity to accept or refuse to accept such material nonpublic information for review and any Investor wishing to obtain such information enters into an appropriate confidentiality agreement with the Company with respect thereto.

5. Obligations of the Investors.

(a) Each Investor shall furnish in writing to the Company such information regarding itself, the Registrable Securities held by it and the intended method of disposition of the Registrable Securities held by it, as shall be reasonably required to effect the registration of such Registrable Securities and shall execute such documents in connection with such registration as the Company may reasonably request. At least five (5) Business Days prior to the first anticipated filing date of any Registration Statement, the Company shall notify each Investor of the information the Company requires from such Investor if such Investor elects to have any of the Registrable Securities included in the Registration Statement. An Investor shall provide such information to the Company at least two (2) Business Days prior to the first anticipated filing date of such Registration Statement if such Investor elects to have any of the Registrable Securities included in the Registration Statement.

(b) Each Investor, by its acceptance of the Registrable Securities agrees to cooperate with the Company as reasonably requested by the Company in connection with the preparation and filing of a Registration Statement hereunder, unless such Investor has notified the Company in writing of its election to exclude all of its Registrable Securities from such Registration Statement.

(c) Each Investor agrees that, upon receipt of any notice from the Company of either (i) the commencement of an Allowed Delay pursuant to Section 2(c)(ii) or (ii) the happening of an event pursuant to Section 3(h) hereof, such Investor will immediately discontinue disposition of Registrable Securities pursuant to the Registration Statement covering such Registrable Securities, until the Investor is advised by the Company that such dispositions may again be made.

6. Indemnification.

(a) Indemnification by the Company. The Company will indemnify and hold harmless each Investor and its officers, directors, members, employees and agents, successors and assigns, and each other person, if any, who controls such Investor within the meaning of the 1933 Act, against any losses, claims, damages or liabilities, joint or several, to which they may become subject under the 1933 Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions in respect thereof) arise out of or are based upon: (i) any untrue statement or alleged untrue statement of any material fact contained in any Registration Statement, any preliminary Prospectus or final Prospectus, or any amendment or supplement thereof; (ii) any blue sky application or other document executed by the Company specifically for that purpose or based upon written information furnished by the Company filed in any state or other jurisdiction in order to qualify any or all of the Registrable Securities under the securities laws thereof (any such application, document or information herein called a “Blue Sky Application”); (iii) the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading; (iv) any violation by the Company or its agents of any rule or regulation promulgated under the 1933 Act applicable to the Company or its agents and relating to action or inaction required of the Company in connection with such registration; or (v) any failure to register or qualify the Registrable Securities included in any such Registration in any state where the Company or its agents has affirmatively undertaken or agreed in writing that the Company will undertake such registration or qualification on an Investor’s behalf and will reimburse such Investor, and each such officer, director or member and each such controlling person for any legal or other expenses reasonably incurred by them in connection with investigating or defending any such loss, claim, damage, liability or action; provided, however, that the Company will not be liable in any such case if and to the extent that any such loss, claim, damage or liability arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission so made in conformity with information furnished by such Investor or any such controlling person in writing specifically for use in such Registration Statement or Prospectus.

(b) Indemnification by the Investors. Each Investor agrees, severally but not jointly, to indemnify and hold harmless, to the fullest extent permitted by law, the Company, its directors, officers, employees, stockholders and each person who controls the Company (within the meaning of the 1933 Act) against any losses, claims, damages, liabilities and expense (including reasonable attorney fees) resulting from any untrue statement of a material fact or any omission of a material fact required to be stated in the Registration Statement or Prospectus or preliminary Prospectus or amendment or supplement thereto or necessary to make the statements therein not misleading, to the extent, but only to the extent that such untrue statement or omission is contained in any information furnished in writing by such Investor to the Company specifically for inclusion in such Registration Statement or Prospectus or amendment or supplement thereto. In no event shall the liability of an Investor be greater in amount than the dollar amount of the proceeds (net of all expense paid by such Investor in connection with any claim relating to this Section 6 and the amount of any damages such Investor has otherwise been required to pay by reason of such untrue statement or omission) received by such Investor upon the sale of the Registrable Securities included in the Registration Statement giving rise to such indemnification obligation.

(c) Conduct of Indemnification Proceedings. Any person entitled to indemnification hereunder shall (i) give prompt notice to the indemnifying party of any claim with respect to which it seeks indemnification and (ii) permit such indemnifying party to assume the defense of such claim with counsel reasonably satisfactory to the indemnified party; provided that any person entitled to indemnification hereunder shall have the right to employ separate counsel and to participate in the defense of such claim, but the fees and expenses of such counsel shall be at the expense of such person unless (a) the indemnifying party has agreed to pay such fees or expenses, or (b) the indemnifying party shall have failed to assume the defense of such claim and employ counsel reasonably satisfactory to such person or (c) in the reasonable judgment of any such person, based upon written advice of its counsel, a conflict of interest exists between such person and the indemnifying party with respect to such claims (in which case, if the person notifies the indemnifying party in writing that such person elects to employ separate counsel at the expense of the indemnifying party, the indemnifying party shall not have the right to assume the defense of such claim on behalf of such person); and provided, further, that the failure of any indemnified party to give notice as provided herein shall not relieve the indemnifying party of its obligations hereunder, except to the extent that such failure to give notice shall materially adversely affect the indemnifying party in the defense of any such claim or litigation. It is understood that the indemnifying party shall not, in connection with any proceeding in the same jurisdiction, be liable for fees or expenses of more than one separate firm of attorneys at any time for all such indemnified parties. No indemnifying party will, except with the consent of the indemnified party, consent to entry of any judgment or enter into any settlement that does not include as an unconditional term thereof the giving by the claimant or plaintiff to such indemnified party of a release from all liability in respect of such claim or litigation.

(d) Contribution. If for any reason the indemnification provided for in the preceding paragraphs (a) and (b) is unavailable to an indemnified party or insufficient to hold it harmless, other than as expressly specified therein, then the indemnifying party shall contribute to the amount paid or payable by the indemnified party as a result of such loss, claim, damage or liability in such proportion as is appropriate to reflect the relative fault of the indemnified party and the indemnifying party, as well as any other relevant equitable considerations. No person guilty of fraudulent misrepresentation within the meaning of Section 11(f) of the 1933 Act shall be entitled to contribution from any person not guilty of such fraudulent misrepresentation. In no event shall the contribution obligation of a holder of Registrable Securities be greater in amount than the dollar amount of the proceeds (net of all expenses paid by such holder in connection with any claim relating to this Section 6 and the amount of any damages such holder has otherwise been required to pay by reason of such untrue or alleged untrue statement or omission or alleged omission) received by it upon the sale of the Registrable Securities giving rise to such contribution obligation.

7. Miscellaneous.

(a) Amendments and Waivers. This Agreement may be amended only by a writing signed by the Company and the Required Investors. The Company may take any action herein prohibited, or omit to perform any act herein required to be performed by it, only if the Company shall have obtained the written consent to such amendment, action or omission to act, of the Required Investors.

(b) Notices. Unless otherwise provided herein, all notices and other communications provided for or permitted hereunder shall be made as set forth in the Warrant Exercise Agreement.

(c) Assignments and Transfers by Investors. The provisions of this Agreement shall be binding upon and inure to the benefit of the Investors and their respective successors and assigns. An Investor may transfer or assign, in whole or from time to time in part, to one or more persons its rights hereunder in connection with the transfer of Registrable Securities by such Investor to such person, provided that such Investor complies with all laws applicable thereto and provides written notice of assignment to the Company promptly after such assignment is effected and such transferee agrees to be bound by the terms and conditions of this Agreement.

(d) Assignments and Transfers by the Company. This Agreement may not be assigned by the Company (whether by operation of law or otherwise) without the prior written consent of the Required Investors, provided, however, that the Company may assign its rights and delegate its duties hereunder to any surviving or successor corporation in connection with a merger or consolidation of the Company with another corporation, or a sale, transfer or other disposition of all or substantially all of the Company's assets to another corporation, without the prior written consent of the Required Investors, after notice duly given by the Company to each Investor.

(e) Benefits of the Agreement. The terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective permitted successors and assigns of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and assigns any rights, remedies, obligations, or liabilities under or by reason of this Agreement, except as expressly provided in this Agreement.

(f) Counterparts; Facsimiles. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. This Agreement may also be executed via facsimile, which shall be deemed an original.

(g) Titles and Subtitles. The titles and subtitles used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

(h) Severability. Any provision of this Agreement that is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof but shall be interpreted as if it were written so as to be enforceable to the maximum extent permitted by applicable law, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction. To the extent permitted by applicable law, the parties hereby waive any provision of law which renders any provisions hereof prohibited or unenforceable in any respect.

(i) Further Assurances. The parties shall execute and deliver all such further instruments and documents and take all such other actions as may reasonably be required to carry out the transactions contemplated hereby and to evidence the fulfillment of the agreements herein contained.

(j) Entire Agreement. This Agreement is intended by the parties as a final expression of their agreement and intended to be a complete and exclusive statement of the agreement and understanding of the parties hereto in respect of the subject matter contained herein. This Agreement supersedes all prior agreements and understandings between the parties with respect to such subject matter.

(k) Governing Law; Consent to Jurisdiction; Waiver of Jury Trial. This Agreement shall be governed by, and construed in accordance with, the internal laws of the State of New York without regard to the choice of law principles thereof. Each of the parties hereto irrevocably submits to the exclusive jurisdiction of the courts of the State of New York located in New York County and the United States District Court for the Southern District of New York for the purpose of any suit, action, proceeding or judgment relating to or arising out of this Agreement and the transactions contemplated hereby. Service of process in connection with any such suit, action or proceeding may be served on each party hereto anywhere in the world by the same methods as are specified for the giving of notices under this Agreement. Each of the parties hereto irrevocably consents to the jurisdiction of any such court in any such suit, action or proceeding and to the laying of venue in such court. Each party hereto irrevocably waives any objection to the laying of venue of any such suit, action or proceeding brought in such courts and irrevocably waives any claim that any such suit, action or proceeding brought in any such court has been brought in an inconvenient forum. **EACH OF THE PARTIES HERETO WAIVES ANY RIGHT TO REQUEST A TRIAL BY JURY IN ANY LITIGATION WITH RESPECT TO THIS AGREEMENT AND REPRESENTS THAT COUNSEL HAS BEEN CONSULTED SPECIFICALLY AS TO THIS WAIVER.**

*[Signature Page Follows]*



IN WITNESS WHEREOF, the parties have executed this Agreement or caused their duly authorized officers to execute this Agreement as of the date first above written.

The Company:

ITERIS, INC.

By: /S/ JAMES S. MIELE  
Name: James S. Miele  
Title: CFO

The Investors:

SPECIAL SITUATIONS FUND III QP, L.P.

By: /S/ AUSTIN W. MARXE  
Name: Austin W. Marxe  
Title: General Partner

SPECIAL SITUATIONS FUND III, L.P.

By: /S/ AUSTIN W. MARXE  
Name: Austin W. Marxe  
Title: General Partner

SPECIAL SITUATIONS CAYMAN FUND, L.P.

By: /S/ AUSTIN W. MARXE  
Name: Austin W. Marxe  
Title: General Partner

SPECIAL SITUATIONS PRIVATE EQUITY FUND, L.P.

By: /S/ AUSTIN W. MARXE  
Name: Austin W. Marxe  
Title: General Partner

### **Plan of Distribution**

The selling stockholders, which as used herein includes donees, pledgees, transferees or other successors-in-interest selling shares of common stock or interests in shares of common stock received after the date of this prospectus from a selling stockholder as a gift, pledge, partnership distribution or other transfer, may, from time to time, sell, transfer or otherwise dispose of any or all of their shares of common stock or interests in shares of common stock on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These dispositions may be at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market price, at varying prices determined at the time of sale, or at negotiated prices.

The selling stockholders may use any one or more of the following methods when disposing of shares or interests therein:

- ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;
- block trades in which the broker-dealer will attempt to sell the shares as agent, but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker-dealer as principal and resale by the broker-dealer for its account;
- an exchange distribution in accordance with the rules of the applicable exchange;
- privately negotiated transactions;
- short sales effected after the date the registration statement of which this Prospectus is a part is declared effective by the SEC;
- through the writing or settlement of options or other hedging transactions, whether through an options exchange or otherwise;
- broker-dealers may agree with the selling stockholders to sell a specified number of such shares at a stipulated price per share; and
- a combination of any such methods of sale.

The selling stockholders may, from time to time, pledge or grant a security interest in some or all of the shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock, from time to time, under this prospectus, or under an amendment to this prospectus under Rule 424(b)(3) or other applicable provision of the Securities Act amending the list of selling stockholders to include the pledgee, transferee or other successors in interest as

selling stockholders under this prospectus. The selling stockholders also may transfer the shares of common stock in other circumstances, in which case the transferees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus.

In connection with the sale of our common stock or interests therein, the selling stockholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the common stock in the course of hedging the positions they assume. The selling stockholders may also sell shares of our common stock short and deliver these securities to close out their short positions, or loan or pledge the common stock to broker-dealers that in turn may sell these securities. The selling stockholders may also enter into option or other transactions with broker-dealers or other financial institutions or the creation of one or more derivative securities which require the delivery to such broker-dealer or other financial institution of shares offered by this prospectus, which shares such broker-dealer or other financial institution may resell pursuant to this prospectus (as supplemented or amended to reflect such transaction).

The aggregate proceeds to the selling stockholders from the sale of the common stock offered by them will be the purchase price of the common stock less discounts or commissions, if any. Each of the selling stockholders reserves the right to accept and, together with their agents from time to time, to reject, in whole or in part, any proposed purchase of common stock to be made directly or through agents. We will not receive any of the proceeds from this offering. Upon any exercise of the warrants by payment of cash, however, we will receive the exercise price of the warrants.

The selling stockholders also may resell all or a portion of the shares in open market transactions in reliance upon Rule 144 under the Securities Act of 1933, provided that they meet the criteria and conform to the requirements of that rule.

The selling stockholders and any underwriters, broker-dealers or agents that participate in the sale of the common stock or interests therein may be “underwriters” within the meaning of Section 2(11) of the Securities Act. Any discounts, commissions, concessions or profit they earn on any resale of the shares may be underwriting discounts and commissions under the Securities Act. Selling stockholders who are “underwriters” within the meaning of Section 2(11) of the Securities Act will be subject to the prospectus delivery requirements of the Securities Act.

To the extent required, the shares of our common stock to be sold, the names of the selling stockholders, the respective purchase prices and public offering prices, the names of any agents, dealer or underwriter, any applicable commissions or discounts with respect to a particular offer will be set forth in an accompanying prospectus supplement or, if appropriate, a post-effective amendment to the registration statement that includes this prospectus.

In order to comply with the securities laws of some states, if applicable, the common stock may be sold in these jurisdictions only through registered or licensed brokers or dealers. In addition, in some states the common stock may not be sold unless it has been registered or qualified for sale or an exemption from registration or qualification requirements is available and is complied with.

We have advised the selling stockholders that the anti-manipulation rules of Regulation M under the Exchange Act may apply to sales of shares in the market and to the activities of the selling stockholders and their affiliates. In addition, to the extent applicable we will make copies of this prospectus (as it may be supplemented or amended from time to time) available to the selling stockholders for the purpose of satisfying the prospectus delivery requirements of the Securities Act. The selling stockholders may indemnify any broker-dealer that participates in transactions involving the sale of the shares against certain liabilities, including liabilities arising under the Securities Act.

We have agreed to indemnify the selling stockholders against certain liabilities, including liabilities under the Securities Act and state securities laws, relating to the registration of the shares offered by this prospectus.

We have agreed with the selling stockholders to keep the registration statement of which this prospectus constitutes a part effective until the earlier of (1) such time as all of the shares covered by this prospectus have been disposed of pursuant to and in accordance with the registration statement or (2) the date on which the shares may be sold pursuant to Rule 144(k) of the Securities Act.

<b>AWARD/CONTRACT</b>		1. THIS CONTRACT IS A RATED ORDER UNDER DPAS (15 CFR 350)		RATING	PAGE OF PAGES 1 31
2. CONTRACT (Proc. Inst. Ident.) NO.  DTFH61-06-D-00030		3. EFFECTIVE DATE  October 1, 2006		4. REQUISITION/PURCHASE REQUEST/PROJECT NO. 21-21-6071 & 21-21-6271	
5. ISSUED BY  Department of Transportation Federal Highway Administration Office of Acquisition Management 400 7 <sup>th</sup> St., S.W., Room 4410, Washington, DC 20590-0001		CODE HAAM 30-D		6. ADMINISTERED BY (If other than Item 6) CODE  Same as Block #5	
7. NAME AND ADDRESS OF CONTRACTOR (No. street, county, state and ZIP Code)  Iteris, Inc.  1515 South Manchester Avenue  Anaheim, CA 92802				8. DELIVERY <input type="checkbox"/> FOB <input checked="" type="checkbox"/> OTHER (See below) ORIGIN	
				9. DISCOUNT FOR PROMPT PAYMENT	
				10. SUBMIT INVOICES (4 copies unless other- wise specified) TO THE ADDRESS SHOWN IN:	ITEM  See Block #5
CODE		FACILITY CODE			
11. SHIP TO/MARK FOR See Part I, Section F		CODE		12. PAYMENT WILL BE MADE BY CODE HAFB24 Federal Highway Administration, Finance Division, Room 4314, 400 7 <sup>th</sup> St., S.W., Washington, DC 20590-0001	
13. AUTHORITY FOR USING OTHER THAN FULL AND OPEN COMPETITION:  <input type="checkbox"/> 10 U.S.C. 2304(c) ( ) <input type="checkbox"/> 41 U.S.C. 253(c) ( )				14. ACCOUNTING AND APPROPRIATION DATA 15X0439060-0000-021J600600-2101000000-25305-61006600 = \$200,000	
15A. ITEM NO.		15B. SUPPLIES/SERVICES		15C. QUANTITY	15D. UNIT
		"National Intelligent Transportation Systems (ITS) Architecture Evolution and Support"			15E. UNIT PRICE
		Total Potential Amount (Including Options): \$24,529,659			15F. AMOUNT
				15G. TOTAL AMOUNT OF CONTRACT \$24,529,659	
16. TABLE OF CONTENTS					
(✓)	SEC.	DESCRIPTION	PAGE(S)	(✓)	SEC.
PART I - THE SCHEDULE				PART II - CONTRACT CLAUSES	
X	A	SOLICITATION/CONTRACT FORM	1	x	I
X	B	SUPPLIES OR SERVICES AND PRICE/COST	2	CONTRACT CLAUSES 28-30	
X	C	DESCRIPTION/SPECS./WORK STATEMENT	3-8	x	J
X	D	PACKAGING AND MARKING	8-9	LIST OF ATTACHMENTS 31	
X	E	INSPECTION AND ACCEPTANCE	9	PART IV - REPRESENTATIONS AND INSTRUCTIONS	
X	F	DELIVERIES OR PERFORMANCE	9-12	K	REPRESENTATIONS, CERTIFICATIONS AND OTHER STATEMENTS OF OFFERORS
X	G	CONTRACT ADMINISTRATION DATA	12-19	L	INSTRS., CONDS., AND NOTICES TO OFFERORS
x	H	SPECIAL CONTRACT REQUIREMENTS	20-27	M	EVALUATION FACTORS FOR AWARD
CONTRACTING OFFICER WILL COMPLETE ITEM 17 OR 18 AS APPLICABLE					
17. <input type="checkbox"/> CONTRACTOR'S NEGOTIATED AGREEMENT (Contractor is required to sign this document and return 9 copies to issuing office.) Contractor agrees to furnish and deliver all items or perform all the services set forth or otherwise identified above and on any continuation sheets for the consideration stated herein. The rights and obligations of the parties to this contract shall be subject to and governed by the following documents: (a) this award/contract, (b) the solicitation, if any, and (c) such provisions, representations, certifications, and specifications, as are attached or incorporated by reference herein. (Attachments are listed herein.)				18. <input type="checkbox"/> AWARD (Contractor is not required to sign this document.) Your offer on Solicitation Number _____, including the additions or changes made by you which additions or changes are set forth in full above, is hereby accepted as to the items listed above and on any continuation sheets. This award consummates the contract which consists of the following documents: (a) the Government's solicitation and your offer, and (b) this award/contract. No further contractual document is necessary.	
19A. NAME AND TITLE OF SIGNER (Type or print) Iteris, Inc. [***]				20A. NAME OF CONTRACTING OFFICER [***]	
19B. NAME OF CONTRACTOR  [***] (Signature of person authorized to sign)		19C. DATE SIGNED  8/29/2006		20B. UNITED STATES OF AMERICA  BY [***] (Signature of Contracting Officer)	
				20C. DATE SIGNED  9/1/06	

NSN 7540-01-152-8069 (REV. 4-85) PREVIOUS EDITION UNUSABLE

Computer Generated

STANDARD FORM 26 Prescribed by GSA FAR (48 CFR) 53.214(a)

\*\*\* Confidential treatment has been requested for the bracketed portions. The confidential redacted portion has been omitted and filed separately with the Securities and Exchange Commission.

**PART I**

**SECTION B - SUPPLIES OR SERVICES AND PRICES/COSTS**

The Contractor shall furnish all the necessary facilities, materials, and personnel and shall perform technical non-personal services and program support necessary under this contract entitled “**National Intelligent Transportation Systems (ITS) Architecture Evolution and Support**”. Such services and program support shall be rendered to the Federal Highway Administration (FHWA) through the issuance of cost-plus-fixed-fee task orders under this Indefinite Delivery/Indefinite Quantity (IDIQ) contract.

The total estimated amount (maximum) for the performance of this indefinite delivery/indefinite quantity contract (Base Period, plus three option years) is \$24,529,659. That amount consists of an estimated total aggregate cost of [\*\*\*] plus an aggregate fee of [\*\*\*].

The estimated amount for the performance of the Base Period (two years) of this contract is \$9,841,693, consisting of an estimated cost of [\*\*\*] plus an aggregate fee of [\*\*\*].

The estimated amount for the performance of the First Option Year (one year) of this contract is \$4,884,756, consisting of an estimated cost of [\*\*\*] plus an aggregate fee of [\*\*\*].

The estimated amount for the performance of the Second Option Year (one year) of this contract is \$4,887,264, consisting of an estimated cost of [\*\*\*] plus an aggregate fee of [\*\*\*].

The estimated amount for the performance of the Third Option Year (one year) of this contract is \$4,915,947, consisting of an estimated cost of [\*\*\*] plus an aggregate fee of [\*\*\*].

All travel shall be reimbursed at cost in accordance with the travel and per diem clause (reference Section G). Travel and per diem shall not exceed [\*\*\*] for the entire period of performance (Base plus all Option Years).

See “LEVEL OF EFFORT REQUIRED TO ACCOMPLISH WORK”, ON PAGE 10, for Minimum Order Amount.

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[\*\*\*] Confidential treatment has been requested for the bracketed portions. The confidential redacted portion has been omitted and filed separately with the Securities and Exchange Commission.

## **SECTION C - DESCRIPTION/SPECIFICATIONS/WORK STATEMENT**

### **BACKGROUND**

A consensus National ITS Architecture was developed in June 1996 to serve as the framework for Intelligent Transportation Systems deployment. It culminated nearly three years of effort by four teams, each representing the private sector, the public sector, and academia. The effort was led by the U.S. DOT, with each team tasked to engage and involve stakeholders from around the country to help shape this national effort.

Following development, the U.S. DOT recognized the need for subsequent ongoing tasks to be accomplished to maximize the return on the investment. The first task is the evolution of the National ITS Architecture – to maintain it in a current status and to integrate new user services as needs are identified and articulated. Modifications have been made based upon input received from deployment programs throughout the country as well as from emerging ITS standards. Version 5.0 of the National ITS Architecture, incorporating the new security additions and other changes, was distributed on CD ROM in December 2003. The next version will likely incorporate other new user services, as well as focus on dedicated short range communications needs and updates in other areas of the Architecture. The National ITS Architecture thus continues to be the definitive and accurate reference for ITS deployment planning.

The second major follow-on task is deployment support. Several levels of workshops were initiated in late 1999 to support Metropolitan Planning Organizations (MPOs) and statewide development of regional and project architectures. More than 100 of these workshops were conducted between CY 2000 and CY 2006. A software tool, Turbo Architecture, was developed and made available for distribution in 2000 to facilitate the process of developing these architectures, using the National ITS Architecture as a reference. Version 3.0 was released in May 2004 to be in synch with the National ITS Architecture Version 5.0 and reflect the FHWA Rule and FTA Policy on Architecture and Standards. A major training program has been successfully executed with more than 150 presentations to over 3000 persons throughout the country. Outreach programs have been supported with presentations being given at major transportation forums throughout the country as well as internationally. Finally, there has been an ongoing effort to support the ITS Standards and the Systems Engineering Programs, both outgrowths of the Architecture Development Program, and ensure that they remain linked as that is essential for the continued deployment of ITS systems.

### **CONTRACT OBJECTIVES**

*The objectives of this contract are to:*

1. Conduct an architecture evolution effort to include evaluating/executing changes due to deployment experiences, changes in requirements, development of ITS standards, and changes in U.S. DOT policy. Integrate new user services into the National ITS.
2. Provide ITS deployment support that enhances the transportation planning process and uses the National ITS Architecture in the development of regional and project architectures.

3. Maintain and support the Turbo Architecture software application. Update it to conform to new versions of the National ITS Architecture.
4. Participate in outreach and training efforts to explain the use of the National ITS Architecture to U.S. DOT resource centers and division offices and assist efforts to explain the use of the Architecture to state and local planners, implementers, integrators, and manufacturers.
5. Assist U.S. DOT policymakers in defining policy consistent with the National ITS Architecture and supporting SAFETEA-LU and subsequent legislation. Ensure that the Architecture reflects new policies.
6. Support the ITS Standards development program and the mapping of ITS standards to the National ITS Architecture.
7. Support the Systems Engineering program including education and outreach.
8. Support coordination with other ITS Joint Program Office (JPO) activities (e.g., the major initiatives, etc.)

#### **SCOPE**

The Contractor will provide for continued technical enhancement and evolution of the National ITS Architecture, which was developed to serve as a framework for national ITS deployments. The Contractor will provide support to the U.S. DOT by ensuring that the National ITS Architecture is maintained and kept up-to-date and reflects all changes, additions, and corrections necessitated by the continually evolving ITS program. The Contractor will ensure the Architecture remains current and inclusive through the integration of new, stakeholder supported user services, and will support the U.S. DOT by providing technical advice regarding policies and actions that might affect the National ITS Architecture. In addition, the Contractor will support the FHWA deployment support program by conducting training and workshops to help explain regional and project architectures to regional/state/local implementers, and performing outreach to the various administrations and their constituents within U.S. DOT that are affected by the National ITS Architecture. Finally, the Contractor will support two programs that are related to and outgrowths of the Architecture Program, the ITS Standards Program and the Systems Engineering Program.

#### **DELINEATION OF WORK**

The Contractor shall not incur costs under the following Tasks A, B, and C except in performing Task Orders.

In order to accomplish the contract objectives, the following list of task areas shall be performed:

##### **Task Area A – Architecture Program Management**

The Contractor will provide advice and recommendations to the U.S. DOT regarding issues that may specifically impact the National ITS Architecture. Specific activities may include:



1. Analyze aspects of the Architecture program, attend regular ITS JPO meetings (policy, quarterly reviews, etc.), and deliver required program status briefings and reports to the U.S. DOT.
2. Review and provide recommendations on the necessary facilities, staff and equipment required to effectively carry out Architecture program objectives.
3. Provide the ITS JPO Architecture Program Manager strategic advice and recommendations concerning the current direction and near-term future of the Architecture program.
4. Consult with and provide recommendations to the ITS JPO Architecture Program Manager on planning issues related to the daily management of the Architecture program, to include maintenance of the National ITS Architecture, architecture and standards policy, and architecture related training and workshops.
5. Provide the ITS JPO Architecture Program Manager advice and consultation regarding contractual issues.
6. Develop papers and make presentations regarding the National ITS Architecture and deployment issues at forums that may include the ITS-America Annual Meeting, the AASHTO Annual Meeting, and the ITE Annual Meeting.
7. Provide the ITS JPO Architecture Program Manager technical advice and reviews of ITS standards development, testing, and deployment efforts, especially as related to the National ITS Architecture.

**Task Area B - Architecture Evolution (Maintenance and New User Services)**

Under the overall management of the U.S. DOT, the Contractor will provide administrative and technical support in maintaining and evolving the National ITS Architecture. Specific activities may include:

1. Maintain architecture configuration control while addressing major and minor updates to the National ITS Architecture documentation.
2. Keep abreast of other ITS developments and deployments that may require changes to the National ITS Architecture and propose such changes when they are identified.
3. Evaluate proposed changes to the National ITS Architecture to determine their impact on the Architecture itself and to other on-going U.S. DOT activities, and integrate them into the National ITS Architecture following ITS JPO approval.
4. Maintain the integrity of the National ITS Architecture documentation set, especially the architecture definition. Provide CD ROM versions of the National ITS Architecture following all major updates. Provide web-based changes to reflect all updates, both major and minor.
5. Integrate new user services into the Architecture in response to the stakeholders' articulating emerging needs and following ITS JPO approval of the new user service.

6. Maintain the Turbo Architecture software tool as required to fully utilize upgrades to the National ITS Architecture definition and to respond to the FHWA Rule and FTA Policy on Architecture and Standards.
7. Participate in architecture related activities within the major U.S. DOT initiatives and integrate relevant elements into the National ITS Architecture.
8. Maintain the National ITS Architecture website and all appropriate documentation, to include the latest versions, major (also on CD ROM) and minor (web based only).

#### **Task Area C – Deployment Support**

The Contractor will provide overall support to the U.S. DOT in ensuring that the National ITS Architecture is considered in all local and national ITS deployments. The Contractor will provide limited training support to public sector (federal) personnel and others as may be subsequently tasked. The Contractor will support architecture outreach efforts to U.S. DOT resource centers and division offices, state and local implementers, the various administrations within the U.S. DOT, and other stakeholders as required. Specific activities may include:

1. Provide technical assistance to the Architecture Field Support Team (AFST), other Federal employees, and FHWA contractors as needed on the National ITS Architecture and regional ITS architecture development, deployment, use, and maintenance. This may be in the context of achieving consistency with the requirements addressed in the FHWA Rule and FTA Policy on Architecture and Standards.
2. Provide regional and project ITS architecture reviews and assessments, including those done on-site.
3. Provide software support for the Turbo Architecture software tool. Provide technical support to Turbo Architecture users.
4. Support development and maintenance of ITS architecture guidance documentation. Coordinate with U.S. DOT and other U.S. DOT contractors in any architecture guidance document development.
5. Develop materials for regional architecture workshops that may involve various aspects of the architecture process to include the regional planning process and the development, use, and maintenance of regional architectures and project architectures.
6. Present architecture workshops (2-day or more) and seminars (1-day) at sites around the country, hosting from one to four different regions, using detailed knowledge of the National ITS Architecture and experience and lessons learned with regional ITS architectures.
7. Support the NHI training courses “Deploying the National ITS Architecture” and “Turbo Architecture Software Training”.
8. Develop issue papers encompassing a wide range of architecture topics including relationship with the transportation planning process, regional and project architectures, security issues, and other current topics involving the National ITS Architecture.

9. Develop and conduct systems engineer process workshops and seminars.
10. Provide systems engineering process technical assistance to the FHWA Division Offices and Resource Centers.
11. Develop white papers and issue papers, as tasked, to address systems engineering and its relationship to the transportation planning process.

## **HARD COPY PUBLICATIONS**

### **Publications for All FHWA Offices**

All applicable reports shall be prepared in accordance with the "Guidelines for Preparing Federal Highway Administration Publications" (FHWA-AD-88-001), dated January 1988, and as amended by Change 1 dated May 20, 1994. Specifically, the contractor shall provide the government with the following for each report developed under this contract:

A completed Technical Report Documentation Page, Form DOT 1700.7 (8-72), which is located via the Internet at <http://www.bts.gov/itc/1770-7.pdf>. This form is necessary to ensure all reports are entered into the National Technical Information Service database.

A printed version of the report: A camera-ready copy (a publication term used to define the finished manuscript), including all artwork (illustrations or photographs) ready for printing by photographic or other means.

An electronic version of the report: An electronic version of the report is necessary to upload into the clearinghouse library (otherwise, scanning in the report is required and this is a time-consuming labor-intensive exercise.) All photographs and negatives used within the report are property of DOT.

## **ELECTRONIC MEDIA**

### **HTML Coding**

For documents (generally under 50 pages) to be coded by DOT staff: To submit electronic files to be coded by DOT staff the document should be sent in Word 2000 or above, with graphic files sent separately in either jpeg or gif format.

For documents over 50 pages to be coded by external sources: All web-enabled documents should be coded in HTML 3.2 or above, to be viewed in Netscape or Internet Explorer browser versions 3.0 or better. Design and function need to be pre-approved by the COTR.

Any scripting beyond HTML needs to be pre-approved by the COTR. Documents should be broken down into manageable files and graphics should either be jpeg or tif and as small as possible (less than 50k). The usage of frames is permissible. Commented code should be used

to support future revisions. Color codes should be hexadecimal, not word codes. These tags should be used: <b>not<strong>, <i>not<em>. Furthermore, <u> (underlining) should not be used. End paragraph tags</p> are not necessary. Animated graphics should not loop endlessly.

## **Graphics**

Request for artwork to be designed for the web should be accompanied by originals (photos, slides, existing artwork, etc.) if possible. These will then be used as reference to check color. Electronic files submitted for inclusion in the graphic should be saved in a jpeg or tif format with a resolution of 300 pixels/inch.

If there is an existing design that the graphic needs to tie into, or if there is a possibility that variations of this graphic may be used in the future, this should be discussed upon submitting graphic request.

## **PRESENTATION MATERIALS**

Presentation materials that are prepared for conferences, briefings, courses, workshops, etc., and developed in electronic format shall be submitted in hard copy format as well as in the program of origin that is acceptable to DOT. Art must be produced in a program that can export an interchange file format that can be imported into other files, such as reports. Photos must be in tif or jpeg format, with on-screen preview and with line screen appropriate for printing.

## **COMPLIANCE WITH REHABILITATION ACT AND ACCESS BOARD STANDARDS**

**In compliance with FAR 39.2 and TAM NOTE 01-03/Section 508 of the Rehabilitation Act, please note the following requirement:**

The Contractor must ensure that any and all electronic documents which it prepares will meet the requirements of Section 508 of the Rehabilitation Act. The Rehabilitation Act requires that all electronic products prepared for the Federal Government be accessible to persons with disabilities, including those with vision, hearing, cognitive, and mobility impairments. **The Contractor can view Section 508 of the Rehabilitation Act (<http://www.accessboard.gov/508.htm>) and the Federal IT Accessibility Initiative (Home Page) (<http://section508.gov/>) for detailed information.**

The FHWA has determined that the accessibility requirements contained in the Electronic and Information Technology Accessibility Standards, Section 1194.22, "Web-based intranet and internet information and applications", apply to this work. The standards are available at [www.access-board.gov/sec508/508standards.htm](http://www.access-board.gov/sec508/508standards.htm).

## **SECTION D - PACKAGING AND MARKING**

### **PACKAGING**

Preservation, packing, and packaging of items for shipment shall be in accordance with commercial practice and adequate for acceptance by common carrier for safe transportation at the most economical rates.

### **SHIPMENT AND MARKING**

Shipment of deliverable items shall be as follows:

Ship to: Federal Highway Administration  
ITS Joint Program Office  
Room 3416  
400 Seventh Street, S.W.  
Washington, DC 20590

ATTN: Lee Simmons, HOIT-1

### **F.O.B. POINT**

The F.O.B. point for all items under this contract is:

Federal Highway Administration  
400 Seventh Street, S.W.  
Washington, DC 20590

**All items shall be shipped F.O.B. Destination.**

## **SECTION E - INSPECTION AND ACCEPTANCE**

All work hereunder shall be subject to review and acceptance by the Government.

### **52.252-2 Clauses Incorporated By Reference (Feb 1998)**

This contract incorporates one or more clauses by reference, with the same force and effect as if they were given in full text. Upon request, the Contracting Officer will make their full text available. Also, the full text of a clause may be accessed electronically at this address: <http://www.arnet.gov/far/> (the Official GSA Site of the Federal Acquisition Regulations (FAR))

52.246-5 Inspection of Services - Cost-Reimbursement. APR 1984

## **SECTION F - DELIVERIES OR PERFORMANCE**

### **PERIOD OF PERFORMANCE**

The period of performance for this contract is twenty-four (24) months from on the effective date of the contract. The period of performance for each specific task order will be determined prior to the effective date of that task order. All work and services hereunder, including preparation and submission of the final report, shall be completed on or before the completion date of this contract, or the date specified on a given task order, whichever is later. Task Orders may be issued up to the final day of this contract, and the contract will remain in force to allow for completion of all Task Orders issued. However, the Government shall not issue, and the Contractor shall not accept, any new task orders issued subsequent to the performance period of this contract.

#### **52.217-9 Option to Extend the Term of the Contract. (MAR 2000)**

(a) The Government may extend the term of this contract by written notice to the Contractor within 30 days before the contract's Base Period ends, provided that the Government gives the Contractor a preliminary written notice of its intent to extend at least 60 days before the contract expires. The preliminary notice does not commit the Government to an extension.

(b) If the Government exercises this option, the extended contract shall be considered to include this option clause.

(c) The total duration of this contract, including the exercise of any options under this clause, shall not exceed 60 months (5 years).

### **LEVEL OF EFFORT REQUIRED TO ACCOMPLISH WORK**

#### **MAXIMUM:**

In the performance of cost-plus-fixed-fee task orders issued during the base period of performance of 24 months (two years) pursuant to this contract, the contractor shall provide a maximum of 65,400 direct productive labor hours of technical effort. Direct productive labor hours are defined as actual work hours exclusive of vacation, holiday, sick leave, and all other absences.

#### **MINIMUM:**

The Government shall order a minimum of \$200,000 for fully burdened effort during the two-year base period.

### **DELIVERABLES/SCHEDULE OF WORK**

The schedule of work and requirements for deliverables shall be performed in accordance with the individual task orders, as negotiated in each Task Order.

## PLACE OF DELIVERY

### A. Invoices

#### To Contracts Office

Submit original and 1 copy of each invoice to:

Federal Highway Administration  
Office of Acquisition Management, HAAM-30D  
400 Seventh Street, S.W., Room 4410  
Washington, D.C. 20590

Attn: Adams JeanPierre  
E-mail: adams.jeanpierre@dot.gov

#### To Contracting Officer's Technical Representative (COTR)

The contractor shall submit to the COTR one copy of each invoice.

### B. Regularly Recurring Reports

#### (1) QUARTERLY PROGRESS REPORTS

#### To Contracting Officer's Technical Representative (COTR)

The contractor shall submit to the COTR **two hard copies** of a Quarterly Progress Report.

#### To Contracting Officer

Submit **one hard copy** of each Quarterly Progress Report to:

Federal Highway Administration  
Office of Acquisition Management, HAAM-30D  
400 Seventh Street, S.W., Room 4410  
Washington, D.C. 20590

Attn: Adams JeanPierre  
E-mail: adams.jeanpierre@dot.gov

#### 52.242-15 STOP-WORK ORDER (AUG 1989) – ALTERNATE I (APR 1984)

- (a) The Contracting Officer may, at any time, by written order to the Contractor, require the Contractor to stop all, or any part, of the work called for by this contract for a period of 90 days after the order is delivered to the Contractor, and for any further period to which the parties may agree. The order shall be specifically identified as a stop-work order issued under this clause. Upon receipt of the order, the Contractor shall immediately

comply with its terms and take all reasonable steps to minimize the incurrence of costs allocable to the work covered by the order during the period of work stoppage. Within a period of 90 days after a stop-work order is delivered to the Contractor, or within any extension of that period to which the parties shall have agreed, the Contracting Officer shall either-

- (1) Cancel the stop-work order; or
  - (2) Terminate the work covered by the order as provided in the Termination clause of this contract.
- (b) If a stop-work order issued under this clause is canceled or the period of the order or any extension thereof expires, the Contractor shall resume work. The Contracting Officer shall make an equitable adjustment in the delivery schedule, the estimated cost, the fee, or a combination thereof, and in any other terms of the contract that may be affected, and the contract shall be modified, in writing, accordingly, if -
- (1) The stop-work order results in an increase in the time required for, or in the Contractor's cost properly allocable to, the performance of any part of this contract; and
  - (2) The Contractor asserts its right to the adjustment within 30 days after the end of the period of work stoppage; provided, that, if the Contracting Officer decides the facts justify the action, the Contracting Officer may receive and act upon a proposal submitted at any time before final payment under this contract.
- (c) If a stop-work order is not canceled and the work covered by the order is terminated for the convenience of the Government, the Contracting Officer shall allow reasonable costs resulting from the stop-work order in arriving at the termination settlement.
- (d) If a stop-work order is not canceled and the work covered by the order is terminated for default, the Contracting Officer shall allow, by equitable adjustment or otherwise, reasonable costs resulting from the stop-work order.  
(End of clause)

**52.252-2 CLAUSES INCORPORATED BY REFERENCE (FEB 1998)**

This contract incorporates one or more clauses by reference, with the same force and effect as if they were given in full text. Upon request, the Contracting Officer will make their full text available.

(End of Clause)

**52.247-34 F.O.B. Destination (NOV 1991)**



## SECTION G - CONTRACT ADMINISTRATION DATA

### **TASK ORDER PROCEDURE**

All funds expended under this contract shall be incurred and accounted for under individual Task Orders.

- (1) Within the Direct Productive labor hours specified in the **LEVEL OF EFFORT REQUIRED TO ACCOMPLISH WORK** clause of this contract, the Contractor shall incur costs under this contract in the performance of task orders and task order modifications issued in accordance with this ordering procedure. No other costs are authorized without the express written consent of the Contracting Officer.
- (2) The work will be conducted by the Contractor on an as-needed basis, within the scope of the contract. The exact nature and extent of the Contractor's work under this contract will be based on written Requests For Task Order Proposals (RFTOP) developed or reviewed by the Contracting Officer's Technical Representative (COTR), who will forward a copy of each written RFTOP to the contractor. Each RFTOP will include, as a minimum, the following:
  - (a) Name of the COTR and Contracting Officer's Task Manager (COTM);
  - (b) Contract Number, due date and time for Government's receipt of proposal(s), and number of required copies of each proposal;
  - (c) Description of the work required;
  - (d) The COTM's estimated maximum number of labor hours or maximum price not-to-exceed, and other resources required;
  - (e) Documentation requirements;
  - (f) The COTM's desired delivery/performance schedule;
  - (g) Quality assurance standards, as appropriate; and
  - (h) Travel authorized
- (3) Within 14 calendar days after receipt of an e-mailed RFTOP from the Government, or within any earlier or later deadline specified in the RFTOP, the Contractor shall submit to the COTR and to the Contracting Officer a Task Order Proposal. (See addresses for COTR and Contracting Officer in Section F of this contract). Each such Task Order Proposal must clearly reference on the outside of the submission envelope, *and* in a *cover letter* the contract number and the particular RFTOP on which the Contractor is proposing. Each such Task Order Proposal shall, at a minimum, contain all of the following:

- (a) Thorough discussion of the technical approach for performing the work, as required by the RFTOP.
  - (b) Period of Performance and Schedule of Work, including an estimated date of commencement of the work.
  - (c) Estimated level of effort, types of staffing and number of hours by sub-task, including those in (e) below.
  - (d) Travel, equipment and materials estimates.
  - (e) An estimate for subcontractors and consultants, including direct labor hours and cost information, if applicable.
  - (f) Estimated cost information broken down by cost element, including any estimated computer usage time, if applicable; and estimated indirect costs and inter-divisional transfer costs.
  - (g) Subject to the *restrictions* stated below, the contractor may include, in any Task Order Proposal, an allowance for managerial and administrative costs estimated to be incurred in connection with that particular Task Order, plus an allowance for any bid and proposal costs estimated to be incurred in submitting a proposal for that particular Task Order. Such allowances, in the aggregate, shall not exceed 5% of all *other* costs being proposed for that particular Task Order **without the prior written consent of the Contracting Officer. Further, the contractor shall never propose, and shall never accept, a double or a multiple recovery of any cost.** Thus, for example, costs billed as direct costs under a Task Order shall not *also* be placed in any of the contractor's *indirect* cost pools. Notwithstanding the permissibility of an estimate for managerial, administrative, and bid & proposal costs under a Task Order, costs shall be *reimbursed* only to the extent that they are actually, allocably, reasonably and allowably *incurred*.
  - (h) Total estimated cost and fixed fee for completion of the Task Order.
- (4) Based on mutual agreement of the estimates, the FHWA will issue a Task Order and the Contractor shall proceed with the conduct of the work.
- (5) Task Orders will contain, as a minimum, the following information:
- (a) Name and signature of the Contracting Officer.
  - (b) Contract Number, Task Order Number, and effective date.
  - (c) Description of task(s) including deliverables.
  - (d) Maximum number of contract labor hours or price not to exceed, and other resources      authorized.
  - (e) Dollar amount of negotiated fixed fee.
-

- (f) Travel authorized.
  - (g) Documentation and reporting requirements.
  - (h) Delivery/performance schedule.
  - (i) Accounting and appropriation data.
  - (j) Any other necessary information.
- (6) The Contracting Officer may modify Task Orders in the same manner as they are issued.
- (7) If the Contractor at any time during work assignment performance has reason to believe that the total incurred cost or number of labor hours will exceed 75% the total estimate set forth in the Task Order, the contractor will immediately notify the Contracting Officer, COTR, and COTM in writing and suggest a revised estimate for completion of the work required there under. The Contracting Officer will make the final determination of the approved cost for each Task Order. **The contractor's cost incurred shall not exceed the total estimated cost specified in each Task Order. Costs incurred that exceed the total estimated cost of a Task Order will not be reimbursed, unless authorized in advance by the Contracting Officer.**
- (8) Any unresolved Task Order terms or conditions should be subject to the **DISPUTES** clause.
- (9) In the event that Task Orders extend beyond the contract's period of performance, the contract will remain in effect to accommodate the completion of the Task Order(s).
- (10) In the event that there is a conflict between the requirements of the contract, the Task Order, or the Contractor's work plan, the contract shall prevail followed in order of precedence by the Task Order and finally, the Contractor's work plan.

#### **QUARTERLY PROGRESS REPORT**

The Contractor shall furnish two (2) hard copies of a quarterly letter-type progress report to the Contracting Officer's Technical Representative and one (1) to the Contracting Officer (CO), on or before the 15<sup>th</sup> of the month following the calendar quarter being reported. Each report shall contain concise statements covering the research activities relevant to the study, including:

1. A brief description of the Task Order objective.
2. Budget and scheduling information including the date the Task Order was initiated, the estimated completion date, original hours and cost estimate, and a tabulation of hours and cost expended this quarter, cumulative total to date, and needed to complete the work.
3. A brief description of the activities conducted under the Task Order during the reporting period.

4. A discussion of any problems encountered or anticipated that might affect successful completion of the Task Order, together with recommended solutions to such problems.
5. Any other pertinent information, including an analysis and explanation of any cost over-runs. Each quarterly progress report shall also contain a budget summary showing planned, actual and cumulative hours and costs for each active Task Order.

#### **ANNUAL PROGRESS REVIEW**

The applicable quarterly reports will be used as part of the annual performance review conducted by the CORT with the contractor. The Contractor shall revise staffing, work assignments, and financial controls, as needed, based on annual performance reviews.

#### **TRAVEL AND PER DIEM**

Travel and Per Diem authorized under this contract shall be reimbursed in accordance with the Government Travel Regulations currently in effect, up to the limit stated in SECTION B. Current per diem rates are listed at:

<http://policyworks.gov/org/main/mt/homepage/mtt/perdiem/travel.shtml>

Travel requirements under this contract shall be met using the most economical form of transportation available. If economy class transportation is not available, higher class transportation shall be approved in advance by the Contracting Officer, and the request for payment voucher must be submitted with justification for use of higher class travel indicating dates, times, and flight numbers. All travel shall be scheduled sufficiently in advance to take advantage of offered discount rates, unless authorized by the Contracting Officer.

The amount of reimbursement shall not exceed the maximum limit authorized in any Task Order. Specific conditions and limitation applicable to travel under this contract are as follows:

1. **Local Travel** - Reimbursement **will not** be allowed for travel to or from the primary place of performance (i.e., Turner-Fairbank Highway Research Center (TFHRC) or DOT Headquarters) for those employees assigned to work under this contract, or to and from the Contractor's local and headquarters office sites, or to and from the employee's residence.
2. **Temporary Assignments** - Any Task Order requiring assignment of Contractor personnel at locations outside the primary place of performance (i.e., TFHRC or DOT Headquarters) for less than 6 months will be considered a temporary assignment. Travel and per diem expenses as allowable, incurred in performing temporary assignments may be billed in accordance with Government Travel Regulations.

#### **CONTRACTING OFFICER'S TECHNICAL REPRESENTATIVE (COTR)**

The Contracting Officer (CO) has designated Lee Simmons as Technical Representative (COTR) to assist in monitoring the work under this contract. The COTR is responsible for the technical administration of the contract and technical liaison with the Contractor. The COTR is NOT

authorized to change the scope of work or specifications as stated in the contract, to make any commitments, to otherwise obligate the Government, or to authorize any changes which affect the contract price, delivery schedule, period of performance, or other terms or conditions.

**The Contracting Officer is the only individual who can legally commit or obligate the Government for the expenditure of public funds. The technical administration of the contract shall not be construed to authorize the revision of the terms and conditions of this contract. The Contracting Officer shall authorize any such revisions in writing.**

#### **FUNDS AVAILABLE**

The clause entitled "LIMITATION OF FUNDS" applies to this contract. Any notification required on the part of the Contractor shall be made in writing to the Contracting Officer with a copy to the COTR. In the event that the contract is not funded beyond the estimated cost set forth in the schedule, the Contractor shall deliver to the Contracting Officer the data collected and the material produced or in process or acquired in connection with the performance of the project provided herein together with a summary report in five copies of its progress and accomplishments to date.

- a. Currently, funds in the amount of two hundred thousand dollars (\$200,000) are obligated to this contract.
- b. Subject to the availability of funds and an executed document by the Contracting Officer, an additional [\*\*\*] may be obligated to this contract.

#### **PAYMENT**

- a. The Contractor may be reimbursed for direct and indirect costs incurred in the performance hereof as are allowable under the provisions of Subpart 31.2, 31.3, 31.6, or 31.7 (as applicable) of the Federal Acquisition Regulations in the not-to-exceed amount of [\*\*\*] subject to the Limitations of Funds Clause.
- b. The Contractor may request monthly interim payments for costs incurred during the performance of this contract. Each monthly interim payment request shall be supported by a statement of costs incurred by the Contractor in the performance of this contract and claimed to constitute allowable costs. Each monthly interim payment request shall be submitted in accordance with Attachment No. 3, "The FHWA Billing Instructions for Cost Reimbursement Contracts" to be considered proper for payment. Prior approval of the Contracting Officer is required if the contractor wishes to use a different payment request form.
- c. In accordance with clause 52.232-25, "Prompt Payment", monthly interim payments will be made by the 30<sup>th</sup> day following receipt of proper request for payment by the designated billing office, unless audit or other review is considered necessary to ensure compliance with the terms and conditions of the contract. All interim payments hereunder will be made upon further determination by the Contracting Officer that the contractor is making adequate progress toward successful contract completion.

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[\*\*\*] Confidential treatment has been requested for the bracketed portions. The confidential redacted portion has been omitted and filed separately with the Securities and Exchange Commission.

- d. Final invoice payment shall be made upon the Contracting Officer's determination that all contract requirements have been completed. The payment due date for the final invoice shall be established in accordance with the clause 52.232-25.
- e. In addition to reimbursing the Contractor for allowable costs, the Government shall pay the Contractor the fee negotiated for each particular Task Order – to the extent that the Task Order is being satisfactorily performed. The Contractor may claim the allocable portion of the fee for any given Task Order, as a part of each applicable monthly interim payment request.

The Contractor shall furnish an original and one (1) copy of each voucher for payment to the Contracting Officer and one (1) copy to the Contracting Officer's Technical Representative.

#### INDIRECT COSTS

Pending the establishment of final indirect cost rates which shall be negotiated based on audit of actual costs as provided in Subpart 42.7 of the Federal Acquisition Regulation, the Contractor shall be reimbursed for allowable indirect costs based on negotiated, provisional indirect rates as identified below:

<u>Indirect Cost</u> <u>Element:</u>	<u>Rate:</u>	<u>Type:</u>	<u>Base (applied to):</u>
Overhead	***	***	***

This INDIRECT COST provision does not operate to waive the LIMITATION OF FUNDS Clause. The Contractor's audited final indirect costs are allowable only insofar as they do not cause the Contractor to exceed the total estimated costs for performance of the contract listed on page 2 (SECTION B) and under the PAYMENT provision above.

#### BILLING RATES

The provisional labor and indirect rates negotiated under this contract for billing purposes shall remain in effect until revised rates have been approved in writing by the Contracting Officer. The Contractor shall request new provisional billing rates in writing, no more frequently than annually. Such request shall delineate the current and proposed rates to be used, along with the proposed effective date of new rates.

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\*\*\* Confidential treatment has been requested for the bracketed portions. The confidential redacted portion has been omitted and filed separately with the Securities and Exchange Commission.

## SUBCONTRACTS - ADVANCE NOTIFICATION AND CONSENT

Under this contract, the requirements of FAR 44.2, CONSENT TO SUBCONTRACTS, have been fulfilled for the following subcontracts:

<u>Subcontractor's Name</u>	<u>Estimated Price for Base Period</u>
Lockheed Martin Corporation	***
Consystec Corporation	***
Ice & Associates	***
Booz Allen Hamilton, Inc.	***

Any future change or revision to the Statement of Work or other applicable aspects of this contract shall include the subcontract(s) only to the extent that performance of the subcontract(s) is directly affected by the change or revision.

### KEY PERSONNEL

#### 1252.237-73 Key Personnel (APR 2005)

#### KEY PERSONNEL (APR 2005)

(a) The personnel as specified below are considered essential to the work being performed under this contract and may, with the consent of the contracting parties, be changed from time to time during the course of the contract by adding or deleting personnel, as appropriate.

(b) Before removing, replacing, or diverting any of the specified individuals, the Contractor shall notify the contracting officer, in writing, before the change becomes effective. The Contractor shall submit information to support the proposed action to enable the contracting officer to evaluate the potential impact of the change on the contract. The Contractor shall not remove or replace personnel under this contract until the Contracting Officer approves the change.

The Key Personnel under this Contract are listed below.

(End of Clause)

The Contractor has designated \*\*\* as the Program Manager (PM) and \*\*\* the Principal Investigator (PI). In the event that either the Program Manager or the Principal Investigator or both is (are) unable to continue performance under this contract, the appointment of a replacement or replacements of equal caliber shall be subject to the prior written approval of the Contracting Officer.

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\*\*\* Confidential treatment has been requested for the bracketed portions. The confidential redacted portion has been omitted and filed separately with the Securities and Exchange Commission.

The Key Personnel and/or Facilities under this Contract: specify key personnel and/or facilities

**Key Personnel Name:**

[\*\*\*]  
[\*\*\*]  
[\*\*\*]  
[\*\*\*]  
[\*\*\*]  
[\*\*\*]  
[\*\*\*]

**Discipline:**

Transportation Engineer  
Systems Engineer  
Systems Engineer  
Systems Engineer  
Systems Engineer  
Transportation Engineer  
Software Engineer

**SECTION H - SPECIAL CONTRACT REQUIREMENTS**

**QUALIFICATIONS OF CONTRACTOR EMPLOYEES (DEVIATION) (MAY 2005) –  
Alternate I (October 2005)**

- a. Definitions. As used in this clause- “Sensitive Information” is any information that, if subject to unauthorized access, modification, loss, or misuse, or is proprietary data, could adversely affect the national interest, the conduct of Federal programs, or the privacy of individuals specified in The Privacy Act, 5 U.S.C. 552a, but has not been specifically authorized under criteria established by an Executive Order or an Act of Congress to be kept secret in the interest of national defense or foreign policy.
- b. Work under this contract may involve access to DOT facilities, sensitive information, or resources (e.g., computer systems). To protect sensitive information, which shall not be disclosed by the contractor unless authorized in writing by the contracting officer, the contractor shall provide training to any contractor employees authorized to access sensitive information, and upon request of the Government, provide information to assist the Government in determining an individual’s suitability to have authorization.
- c. The Contracting Officer may require dismissal from work under this contract those employees deemed incompetent, careless, insubordinate, unsuitable, or otherwise objectionable, or whose continued employment is deemed contrary to the public interest or inconsistent with the best interest of national security.
- d. Contractor employees working on this contract must complete such forms, as may be necessary for security or other reasons, including the conduct of background investigations to determine suitability. Completed forms shall be submitted as directed by the Contracting Officer. Upon the Contracting Officer’s Technical Representative (COTR) or Project/Program Manager (PM) request, the Contractor’s employees shall be fingerprinted, or subject to other investigations as required.
- e. The Contractor shall ensure that contractor employees are citizens of the United States of America or an alien who has been lawfully admitted for permanent residence or employment

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[\*\*\*] Confidential treatment has been requested for the bracketed portions. The confidential redacted portion has been omitted and filed separately with the Securities and Exchange Commission.



(indicated by immigration status) as evidenced Bureau of Citizenship and Immigration Services documentation; and

f. The Contractor shall immediately notify the COTR or PM when an employee's status changes (e.g., employee's transfer, completion of a project, retirement or termination of employment) that may affect the employee's eligibility for access to the facility, sensitive information, or resources.

g. To ensure the requirements of FIPS 201, Personal Identity Verification (PIV) of Federal Employees and Contractors, are met, the Contractor shall:

1. Provide a listing of personnel from whom an identification (ID) card is requested to the COTR or PM who will provide a copy of the listing to the card issuing office. This may include Contractor and subcontractor personnel. Following issuing office directions for submittal of an application package.
2. While visiting or performing work on a DOT facility, as specified by the issuing office, PM or COTR, ensure that contractor employees prominently display their identification card.
3. Promptly deliver to the issuing office: (1) all ID cards assigned to an employee who no longer requires access to the facility; and (2) all expired ID cards within five (5) days of their expiration or all cards at time of contract termination, whichever occurs first.
4. Immediately report any lost or stolen ID cards to the issuing office and follow their instructions.

h. The Contractor shall include the substance of this clause in all subcontracts at any tier where the subcontractor may have access to Government facilities, sensitive information, or resources.

i. Failure to comply with these requirements may result in withholding of final payment.

**(End of clause)**

#### **52.232-33 Payment by Electronic Funds Transfer - Central Contractor Registration (OCT 2003)**

(a) *Method of payment.* (1) All payments by the Government under this contract shall be made by electronic funds transfer (EFT), except as provided in paragraph (a)(2) of this clause. As used in this clause, the term "EFT" refers to the funds transfer and may also include the payment information transfer.

(2) In the event the Government is unable to release one or more payments by EFT, the Contractor agrees to either -

(i) Accept payment by check or some other mutually agreeable method of payment; or

(ii) Request the Government to extend the payment due date until such time as the Government can make payment by EFT (but see paragraph (d) of this clause).

(b) *Contractor's EFT information.* The Government shall make payment to the Contractor using the EFT information contained in the Central Contractor Registration (CCR) database. In the event that the EFT information changes, the Contractor shall be responsible for providing the updated information to the CCR database.

(c) *Mechanisms for EFT payment.* The Government may make payment by EFT through either the Automated Clearing House (ACH) network, subject to the rules of the National Automated Clearing House Association, or the Fedwire Transfer System. The rules governing Federal payments through the ACH are contained in 31 CFR part 210.

(d) *Suspension of payment.* If the Contractor's EFT information in the CCR database is incorrect, then the Government need not make payment to the Contractor under this contract until correct EFT information is entered into the CCR database; and any invoice or contract financing request shall be deemed not to be a proper invoice for the purpose of prompt payment under this contract. The prompt payment terms of the contract regarding notice of an improper invoice and delays in accrual of interest penalties apply.

(e) *Liability for uncompleted or erroneous transfers.* (1) If an uncompleted or erroneous transfer occurs because the Government used the Contractor's EFT information incorrectly, the Government remains responsible for -

(i) Making a correct payment;

(ii) Paying any prompt payment penalty due; and

(iii) Recovering any erroneously directed funds.

(2) If an uncompleted or erroneous transfer occurs because the Contractor's EFT information was incorrect, or was revised within 30 days of Government release of the EFT payment transaction instruction to the Federal Reserve System, and -

(i) If the funds are no longer under the control of the payment office, the Government is deemed to have made payment and the Contractor is responsible for recovery of any erroneously directed funds; or

(ii) If the funds remain under the control of the payment office, the Government shall not make payment, and the provisions of paragraph (d) of this clause shall apply.

(f) *EFT and prompt payment.* A payment shall be deemed to have been made in a timely manner in accordance with the prompt payment terms of this contract if, in the EFT payment transaction instruction released to the Federal Reserve System, the date specified for settlement of the payment is on or before the prompt payment due date,

provided the specified payment date is a valid date under the rules of the Federal Reserve System.

(g) EFT and assignment of claims. If the Contractor assigns the proceeds of this contract as provided for in the assignment of claims terms of this contract, the Contractor shall require as a condition of any such assignment, that the assignee shall register separately in the CCR database and shall be paid by EFT in accordance with the terms of this clause. Notwithstanding any other requirement of this contract, payment to an ultimate recipient other than the Contractor, or a financial institution properly recognized under an assignment of claims pursuant to subpart 32.8, is not permitted. In all respects, the requirements of this clause shall apply to the assignee as if it were the Contractor. EFT information that shows the ultimate recipient of the transfer to be other than the Contractor, in the absence of a proper assignment of claims acceptable to the Government, is incorrect EFT information within the meaning of paragraph (d) of this clause.

(h) Liability for change of EFT information by financial agent. The Government is not liable for errors resulting from changes to EFT information made by the Contractor's financial agent.

(i) *Payment information.* The payment or disbursing office shall forward to the Contractor available payment information that is suitable for transmission as of the date of release of the EFT instruction to the Federal Reserve System. The Government may request the Contractor to designate a desired format and method(s) for delivery of payment information from a list of formats and methods the payment office is capable of executing. However, the Government does not guarantee that any particular format or method of delivery is available at any particular payment office and retains the latitude to use the format and delivery method most convenient to the Government. If the Government makes payment by check in accordance with paragraph (a) of this clause, the Government shall mail the payment information to the remittance address contained in the CCR database.

(End of clause)

## **NONPERSONAL SERVICES CONTRACT**

This contract is a "nonpersonal" services contract" as defined in the FAR at subpart 37.101. It is understood and agreed that the contractor and/or contractor's employees and subcontractors: (1) shall perform the services specified herein as independent contractors, not as employees of the government; (2) shall be responsible for their own management and administration of the work required and bear sole responsibility for complying with any and all technical, schedule, or financial requirements or constraints attendant to the performance of this contract; (3) shall be free from supervision or control by any government employee with respect to the manner or method of performance of the services specified; but (4) shall, pursuant to the government's right and obligation to inspect, accept or reject the work, comply with such general direction of the contracting officer, or the duly authorized representative of the contracting officer as is necessary to ensure accomplishment of the contract objectives.

## **LIABILITY**

The Government cannot indemnify the Contractor or its subcontractor(s) from liability as a result of the performance of work under this contract. Therefore, the Contractor is required to obtain adequate property, vehicle and liability insurance during the entire period of performance, as appropriate, in accordance with the provisions of the clause at FAR 52.228-5, which is incorporated into this contract in Section I. **Evidence of such insurance must be submitted to the Contracting Officer as a condition of award.**

## **GOVERNMENT FURNISHED OR ACQUIRED PROPERTY**

Any Government furnished or contractor acquired property provided or obtained under the performance of this contract shall be accounted for as provided in Transportation Acquisition Regulation (TAR) Subpart 1245.5, and by complying with the following provision:

### **1252.245-70 GOVERNMENT PROPERTY REPORTS (OCT 1994)**

- (a) The contractor shall prepare an annual report of Government property in its possession and the possession of its subcontractors.
- (b) The report shall be submitted to the Contracting Officer not later than September 15 of each calendar year on Form DOT F 4220.43, Contractor Report of Government Property.

## **QUALITY ASSURANCE STATEMENT**

The Federal Highway Administration (FHWA) provides high-quality information to serve Government, industry, and the public in a manner that promotes public understanding. Standards and policies are used to ensure and maximize the quality, objectivity, utility, and integrity of its information. FHWA periodically reviews quality issues and adjusts its programs and processes to ensure continuous quality improvement.

## **REPRINTS OF PUBLICATIONS**

At such time that any article resulting from work under this contract is published, two reprints of the publication shall be sent to the COTR, clearly referencing this contract number and any other appropriate handling information. Written notification shall also be provided to the Contracting Officer.

## **SITE VISITS**

The FHWA, through its authorized representative, has the right at all reasonable times, to make site visits for the purpose of reviewing the project accomplishments and management control systems, and to provide technical assistance and guidance as may be required. If any site visit is made by the FHWA on the premises of the Contractor, a team member, or a subcontractor performing work under the contract, same will provide and will require their subcontractor(s) to provide all reasonable facilities and assistance for the safety and convenience of the FHWA and

other Government representatives, in the performance of their duties. Such visits may be either announced or unannounced.

#### **POST-AWARD EVALUATION OF CONTRACTOR PERFORMANCE**

##### **a. Contractor Performance Evaluations**

Annual and final evaluations of contractor performance will be prepared on this contract in accordance with FAR 42.15 (or FAR 36.201 for construction, or FAR 36.604 for Architect-Engineering). The final performance evaluations will be prepared at the time of completion of work. Annual and final evaluations will be provided to the contractor as soon as practicable after completion of the evaluation. The contractor can elect to review the evaluation and submit additional information or a rebuttal statement. The contractor will be permitted thirty days to respond. Contractor response is voluntary and is not mandatory. Any disagreement between the parties regarding an evaluation will be referred to an individual at a level above the Contracting Officer, whose decision is final.

Copies of the evaluations, contractor responses, and review comments, if any, will be retained as part of the contract file, and may be used to support future award decisions.

##### **b. Electronic Access to Contractor Performance Evaluations**

FAR 42.15 requires agencies to prepare annual and final evaluations of contractor performance. The U. S. Department of Transportation utilizes the National Institutes of Health (NIH) Contractor Performance System (CPS) to record and maintain past performance information. The CPS module for architect-engineer contracts is not yet available. Therefore, the following information regarding electronic access does not apply to architect-engineer contracts. Contractors that have Internet capability may access evaluations through a secure Web site for review and comment by completing the registration form that can be obtained at the following URL: <https://www.cpscontractor.nih.gov/>.

The registration process requires the contractor to identify an individual who will serve as a primary contact and who will be authorized access to the evaluation for review and comment. In addition, the contractor will be required to identify a secondary contact who will be responsible for notifying the cognizant contracting official in the event the primary contact is unavailable to process the evaluation within the required 30-day time period. Once the contractor is registered and a performance evaluation has been prepared and is ready for comment, the CPS will send an e-mail to the contractor representative notifying that individual that a performance evaluation is electronically available for review and comment.

END OF CLAUSE

#### **PROTECTION OF INFORMATION AND LIMITATION OF FUTURE CONTRACTING**

- a. It is anticipated that in performance of this contract, the Contractor may require access to or receipt of information and data relating to FHWA's plans, programs, technical requirements, and budgetary matters, and such other information, the disclosure of which

may give competitive advantage to recipients or would be adverse to the interest of the Government.

- b. The Contractor shall not disclose such information acquired to anyone, other than those Contractor, subcontractor, or consultant personnel performing work under this contract, without the prior written consent of the Contracting Officer, until such time as the Government may have authorized the release of such information and data to the public.
- c. To the extent that the work under this contract requires access to proprietary, business confidential, or financial data of other companies, and as long as such data remains proprietary or confidential, the Contractor shall protect such data from unauthorized use and disclosure and agrees not to use it to compete against such companies.
- d. It is anticipated that during performance of this contract, the Contractor may be issued Task Orders involving technical evaluation of other Contractor's offers or products. FAR 9.505-3 provides that contracts shall not generally be awarded to a Contractor that would evaluate or advise the Government concerning its own products or activities or those of a competitor without proper safeguards to ensure objectivity and protect the Government's interests. These safeguards will be accomplished by restricting future contracting with the Government as delineated below.
- e. FHWA will not unilaterally disclose to the Contractor any proprietary information furnished by domestic or foreign participants in FHWA's programs. If the Contractor requires access to such information in performance of this contract, an agreement concerning release and restrictions on the use of such data must be sought by the Contractor with the source of the data.
- f. It is agreed by the parties of this contract that the Contractor will be restricted in its future contracting with Government in the manner described below in this sub-section f. Except as specifically provided below in the sub-section f, the Contractor shall be free to compete for FHWA business on an equal basis with other companies. If the Contractor, under the terms of this contract, acquires or obtains information specified in paragraphs a or c of this section and if that information is not publicly available and could give the Contractor a competitive advantage in subsequent procurements or would be adverse to the interests of the Government, then the Contractor shall be ineligible to perform as a prime contractor, subcontractor or consultant, or in any capacity to any supplier under an ensuing Government contract. Further, if the Contractor, under the terms of this contract, is required to develop specifications or a statement of work, or to develop materials leading directly, predictably or without delay to a statement of work to be used in the competitive procurement of a system or services, the Contractor shall be ineligible to perform the work described within that solicitation as a prime contractor, subcontractor, consultant, or in any capacity to any supplier under an ensuing FHWA contract. Any questions on this matter shall be immediately addressed to the Contracting Officer.
- g. These restrictions do not limit the Contractor's right to use and disclose any information and data obtained from another source without restriction.
- h. The Contractor agrees to train its employees who will have access to such sensitive information in all necessary security procedures and require them to sign non-disclosure

statements and certificates attesting to their understanding of the requirements for safeguarding such information.

- i. In the event that the Contractor fails to comply with this provision of the contract, the Government may terminate the contract for default.
- j. The Contractor shall include this provision, including this paragraph, in all subcontracts and consultant agreements for performance of work under this contract unless excused in writing by the Contracting Officer.

#### **COMPUTER RELATED SERVICES**

The primary purpose of this contract is *not* to perform ADP services or computer services. (The mere use of personal computers and common off-the-shelf programs – for word-processing, desk-top publishing, spreadsheets, e-mails, and the creation and manipulation of graphics – is *not* considered “computer related services”).

*However*, in the performance of one or more task orders, there is a *possibility* that the Contractor might be required to create or to modify a web site, or might be required to create or modify a database, or might provide other technical collaboration/support using computers. *If* any technical work of the type described in this paragraph were ever required, it would be *specified* in the applicable task order(s). Any such technical work shall be carefully coordinated with the COTR to ensure that the work complies with any FHWA ADP standards applicable at that time.

All requirements for compliance with the accessibility standards of Section 508 of the Rehabilitation Act will be specified in the applicable Task Orders.

#### **SOURCE CODE FOR SOFTWARE**

In the event that source code is first produced under this contract, delivery of all source code for all software developed hereunder shall be in both electronic and paper format.

#### **52.224-1 Privacy Act Notification (APR 1984)**

The Contractor will be required to design, develop, or operate a system of records on individuals, to accomplish an agency function subject to the Privacy Act of 1974, Public Law 93-579, December 31, 1974 (5 U.S.C. 552a) and applicable agency regulations. Violation of the Act may involve the imposition of criminal penalties.

## PART II

### SECTION I - CONTRACT CLAUSES

#### 52.237-3 CONTINUITY OF SERVICES (JAN 1991)

[In accordance with Iteris' request, subparagraph "c" of the CONTINUITY OF SERVICES clause is hereby **modified** so as to read as follows:]

- “(c) The Contractor shall allow as many personnel as practicable to remain on the job to help the successor maintain the continuity and consistency of the services required by this contract. Personnel records will only be released to the successor with employee permission. If selected employees are agreeable to the change, the Contractor shall release them at a mutually agreeable date.”

#### 52.252-2 Clauses Incorporated by Reference. (FEB 1998)

This contract incorporates one or more clauses by reference, with the same force and effect as if they were given in full text. Upon request, the Contracting Officer will make their full text available. Also, the full text of a clause may be accessed electronically at this/these address(es): <http://www.arnet.gov/far/> (the Official General Services Administration (GSA) Site of the Federal Acquisition Regulations (FAR)); <http://www.dot.gov/ost/m60/tamtar/tar.htm> (the Official DOT Site of the Transportation Acquisition Regulations (TAR)).

#### I. FEDERAL ACQUISITION REGULATION (48 CFR CHAPTER 1) CLAUSES

1.	52.202-1	Definitions (JUL 2004)
2.	52.203-3	Gratuities (APR 1984)
3.	52.203-5	Covenant Against Contingent Fees (APR 1984)
4.	52.203-6	Restrictions on Sub-Contractor Sales to the Government (JUL 1995)
5.	52.203-7	Anti-Kickback Procedures (JUL 1995)
6.	52.203-8	Cancellation, Rescission, and Recovery of Funds for Illegal or Improper Activity (JAN 1997)
7.	52.203-10	Price or Fee Adjustment for Illegal or Improper Activity (JAN 1997)
8.	52.203-12	Limitations on Payments to Influence Certain Federal Transactions (SEP 2005)
9.	52.204-4	Printing/Copying Double-sided on Recycled Paper (AUG 2000)
10.	52.204-7	Central Contractor Registration (JULY 2006)
11.	52.209-6	Protecting the Government's Interest When Subcontracting With Contractors Debarred, Suspended, or Proposed for Debarment (JAN 2005)
12.	52.215-2	Audit and Records – Negotiation (JUN 1999)
13.	52.215-8	Order of Precedence – Uniform Contract Format (OCT 1997)
14.	52.215-10	Price Reduction for Defective Cost or Pricing Data (OCT 1997)
15.	52.215-11	Price Reduction for Defective Cost or Pricing Data – Modifications (OCT 1997)
16.	52.215-12	Sub-Contractor Cost or Pricing Data (OCT 1997)
17.	52.215-13	Sub-Contractor Cost or Pricing Data – Modifications (OCT 1997)
18.	52.215-15	Pension Adjustments and Asset Reversions (OCT 2004)



19.	52.215-17	Waiver of Facilities Capital Cost of Money (OCT 1997)
20.	52.215-18	Reversion or Adjustment of Plans for Post Retirement Benefits (PRB) Other than Pensions (JUL 2005)
21.	52.215-19	Notifications of Ownership Changes (OCT 1997)
22.	52.215-21	Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data – Modifications (OCT 1997)
23.	52.216-7	Allowable Cost and Payment (DEC 2002)
24.	52.216-8	Fixed Fee (MAR 1997)
25.	52.216-18	Ordering (OCT 1995)
26.	52.216-22	Indefinite Quantity (OCT 1995)
27.	52.219-4	Notice Of Price Evaluation For HUBZone Small Business Concerns (JAN 1999)
28.	52.219-8	Utilization Of Small Business Concerns (MAY 2004)
29.	52.219-9	Small Business Subcontracting Plan (JULY 2005)
30.	52.219-16	Liquidated Damages – Subcontracting Plan (JAN 1999)
31.	52.222-3	Convict Labor (JUN 2003)
32.	52.222-21	Prohibition of Segregated Facilities (FEB 1999)
33.	52.222-26	Equal Opportunity (APR 2002)
34.	52.222-35	Equal Opportunity for Special Disabled Veterans, Veterans of the Vietnam Era, and Other Eligible Veterans (DEC 2001)
35.	52.222-36	Affirmative Action for Workers with Disabilities (JUN 1998)
36.	52.222-37	Employment Reports on Special Disabled Veterans and Veterans of the Vietnam Era (DEC 2001)
37.	52.223-5	Pollution Prevention and Right-to-Know Information (APR 1998)
38.	52.223-6	Drug-Free Workplace (MAY 2001)
39.	52.223-14	Toxic Chemical Release Reporting (AUG 2003)
40.	52.224-2	Privacy Act (APR 1984)
41.	52.225-13	Restrictions on Certain Foreign Purchases (FEB 2006)
42.	52.225-14	Inconsistency between English Version and Translation of Contract (FEB 2000)
43.	52.226-1	Utilization of Indian Organizations and Indian Owned Economic Enterprises (JUN 2000)
44.	52.227-1	Authorization and Consent (JUL 1995)
45.	52.227-2	Notice and Assistance Regarding Patent and Copyright Infringement (AUG 1996)
46.	52.227-11	Patent Rights – Retention by the Contractor (Short Form) (JUN 1997)
47.	52.227-14	Rights in Data – General (JUN 1987)
48.	52.227-19	Commercial Computer Software – Restricted Rights (JUN 1987)
49.	52.228-7	Insurance – Liability to Third Persons (MAR 1996)
50.	52.230-2	Cost Accounting Standards (APR 1998)
51.	52.230-3	Disclosure and Consistency of Cost Accounting Practices (APR 1998)
52.	52.230-6	Administration of Cost Accounting Standards (APR 2005)
53.	52.232-9	Limitation on Withholding of Payments (APR 1984)
54.	52.232-17	Interest (JUN 1996)
55.	52.232-22	Limitation of Funds (APR 1984)
56.	52.232-23	Assignment of Claims (JAN 1986)
57.	52.232-25	Prompt Payment (OCT 2003)
58.	52.233-1	Disputes (JUL 2002)
59.	52.233-3	Protest After Award (AUG 1996) – Alternate I (JUN 1985)
60.	52.233-4	Applicable Law for Breach of Contract Claim (OCT 2004)

61.	52.237-2	Protection of Government Buildings, Equipment, and Vegetation (APR 1984)
62.	52.237-3	Continuity of Services (JAN 1991)
63.	52.237-10	Identification of Uncompensated Overtime (OCT 1997)
64.	52.242-1	Notice of Intent to Disallow Costs (APR 1984)
65.	52.242-3	Penalties for Unallowable Costs (MAY 2001)
66.	52.242-4	Certification of Final Indirect Costs (JAN 1997)
67.	52.242-13	Bankruptcy (JUL 1995)
68.	52.243-2	Changes – Cost-Reimbursement (AUG 1987) – Alternate I (APR 1984)
69.	52.244-2	Subcontracts (AUG 1998) – Alternate I (JAN 2006)
70.	52.244-6	Subcontracts for Commercial Items (FEB 2006)
71.	52.244-5	Competition in Subcontracting (DEC 1996)
72.	52.245-1	Property Records (APR 1984)
73.	52.245-5	Government Property (Cost-Reimbursement, Time-and-Material, or Labor-Hour Contracts) (MAY 2004)
74.	52.245-19	Government Property Furnished “As Is” (APR 1984)
75.	52.246-25	Limitation of Liability – Services (FEB 1997)
76.	52.247-34	FOB Destination (NOV 1991)
77.	52.249-6	Termination (Cost-Reimbursement) (MAY 2004)
78.	52.249-14	Excusable Delays (APR 1984)
79.	52.253-1	Computer Generated Forms (JAN 1991)

## **II. DEPARTMENT OF TRANSPORTATION ACQUISITION REGULATIONS (48 CHAPTER 12) CLAUSES**

80.	1252.223-73	Seat Belt Use Policies and Programs (MAY 2005)
81.	1252.237-71	Certification of Data (APR 2005)
82.	1252.242-71	Contract Testimony (OCT 1994)
83.	1252.242-72	Dissemination of Contract Information (OCT 1994)
84.	1252.242-73	Contracting Officer’s Technical Representative (OCT 1994)

### **52.252-4 Alterations in Contract. (APR 1984)**

Portions of this contract are altered as follows: None

**P A R T   I I I**

**SECTION J - LIST OF ATTACHMENTS**

1.      Standard Form LLL, Disclosure of Lobbying Activities - 2 pages
2.      FHWA Billing Instructions for Cost Reimbursement Contracts - 4 pages

## LOAN AND SECURITY AGREEMENT

**THIS LOAN AND SECURITY AGREEMENT** (this “**Agreement**”) dated as of the Effective Date between **SILICON VALLEY BANK**, a California corporation (“**Bank**”), and **ITERIS, INC.**, a Delaware corporation (“**Borrower**”), provides the terms on which Bank shall lend to Borrower and Borrower shall repay Bank. The parties agree as follows:

### 1 ACCOUNTING AND OTHER TERMS

Accounting terms not defined in this Agreement shall be construed following GAAP. Calculations and determinations must be made following GAAP. Capitalized terms not otherwise defined in this Agreement shall have the meanings set forth in Section 13. All other terms contained in this Agreement, unless otherwise indicated, shall have the meaning provided by the Code to the extent such terms are defined therein.

### 2 LOAN AND TERMS OF PAYMENT

**2.1 Promise to Pay.** Borrower hereby unconditionally promises to pay Bank the outstanding principal amount of all Credit Extensions and accrued and unpaid interest thereon as and when due in accordance with this Agreement.

#### **2.1.1 Revolving Advances.**

(a) Availability. Subject to the terms and conditions of this Agreement and to deduction of Reserves, Bank will make Advances to Borrower up to an amount (“**Net Borrowing Availability**”) not to exceed the lesser of: (a) the Revolving Line; or (b) the amounts available under the Borrowing Base.

(b) Streamline Period. [omitted]

(c) Termination; Repayment. The Revolving Line terminates on the Revolving Line Maturity Date, when the principal amount of all Advances, the unpaid interest thereon, and all other Obligations relating to the Revolving Line shall be immediately due and payable.

#### **2.1.2 Letters of Credit Sublimit.**

(a) As part of the Revolving Line, Bank shall issue or have issued Letters of Credit for Borrower’s account. The face amount of outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit and any Letter of Credit Reserve) may not exceed the Availability Amount. Such aggregate amounts utilized hereunder shall at all times reduce the amount otherwise available for Advances under the Revolving Line. If, on the Revolving Line Maturity Date, there are any outstanding Letters of Credit, then on such date Borrower shall provide to Bank cash collateral in an amount equal to 105% of the face amount of all such Letters of Credit plus all interest, fees, and costs due or to become due in connection therewith (as estimated by Bank in its good faith business judgment), to secure all of the Obligations relating to said Letters of Credit. All Letters of Credit shall be in form and substance acceptable to Bank in its sole discretion and shall be subject to the terms and conditions of Bank’s standard Application and Letter of Credit Agreement (the “**Letter of Credit Application**”). Borrower agrees to execute any further documentation in connection with the Letters of Credit as Bank may reasonably request. Borrower further agrees to be bound by the regulations and interpretations of the issuer of any Letters of Credit guaranteed by Bank and opened for Borrower’s account or by Bank’s interpretations of any Letter of Credit issued by Bank for Borrower’s account, and Borrower understands and agrees that Bank shall not be liable for any error, negligence, or mistake, whether of omission or commission, in following Borrower’s instructions or those contained in the Letters of Credit or any modifications, amendments, or supplements thereto; but nothing herein shall relieve Bank from liability for its own gross negligence or willful misconduct.

(b) The obligation of Borrower to immediately reimburse Bank for drawings made under Letters of Credit shall be absolute, unconditional, and irrevocable, and shall be performed strictly in accordance with the terms of this Agreement, such Letters of Credit, and the Letter of Credit Application.

(c) Borrower may request that Bank issue a Letter of Credit payable in a Foreign Currency. If a demand for payment is made under any such Letter of Credit, Bank shall treat such demand as an Advance to Borrower of the equivalent of the amount thereof (plus fees and charges in connection therewith such as wire, cable,

SWIFT or similar charges) in Dollars at the then-prevailing rate of exchange in San Francisco, California, for sales of the Foreign Currency for transfer to the country issuing such Foreign Currency.

(d) To guard against fluctuations in currency exchange rates, upon the issuance of any Letter of Credit payable in a Foreign Currency, Bank shall create a reserve (the **"Letter of Credit Reserve"**) under the Revolving Line in an amount equal to ten percent (10%) of the face amount of such Letter of Credit. The amount of the Letter of Credit Reserve may be adjusted by Bank from time to time to account for fluctuations in the exchange rate. The availability of funds under the Revolving Line shall be reduced by the amount of such Letter of Credit Reserve for as long as such Letter of Credit remains outstanding.

**2.1.3 Foreign Exchange Sublimit.** As part of the Revolving Line, Borrower may enter into foreign exchange contracts with Bank under which Borrower commits to purchase from or sell to Bank a specific amount of Foreign Currency (each, a **"FX Forward Contract"**) on a specified date (the **"Settlement Date"**). FX Forward Contracts shall have a Settlement Date of at least one (1) FX Business Day after the contract date and shall be subject to a reserve of ten percent (10%) of each outstanding FX Forward Contract in a maximum aggregate amount equal to **\$1,000,000** (the **"FX Reserve"**). The aggregate amount of FX Forward Contracts at any one time may not exceed ten (10) times the amount of the FX Reserve.

**2.1.4 Cash Management Services Sublimit.** Borrower may use up to **\$1,000,000** (the **"Cash Management Services Sublimit"**) of the Revolving Line for Bank's cash management services which may include merchant services, direct deposit of payroll, business credit card, and check cashing services identified in Bank's various cash management services agreements (collectively, the **"Cash Management Services"**). Any amounts Bank pays on behalf of Borrower or any amounts that are not paid by Borrower for any Cash Management Services will be treated as Advances under the Revolving Line and will accrue interest at the interest rate applicable to Advances.

**2.1.5 Overall Aggregate Sublimit.** In no event shall the total amount of (i) outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit and any Letter of Credit Reserve), and (ii) the FX Reserve, and (iii) the amount of the Revolving Line utilized for Cash Management Services, at any time exceed **\$1,000,000** in the aggregate.

**2.1.6 Term Loan.**

(a) Availability. Bank shall make one (1) term loan available to Borrower in an amount up to the Term Loan Amount on the Effective Date subject to the satisfaction of the terms and conditions of this Agreement.

(b) Repayment. Borrower shall repay the Term Loan in (i) twenty (20) equal installments of principal in the amount of not less than \$104,600 each (the actual amount of the installments shall be determined based upon the actual amount of the Term Loan Amount), plus (ii) monthly payments of accrued interest (the **"Term Loan Payment"**). Beginning on the last day of the month in which the Funding Date occurs, each Term Loan Payment shall be payable on the last day of each month. Borrower's final Term Loan Payment, due on the earlier of (a) the date the Loan Agreement is terminated or (b) the Term Loan Maturity Date, shall include all outstanding principal and accrued and unpaid interest under the Term Loan.

(c) Term Loan Reserve. Notwithstanding the foregoing, an amount equal to the currently outstanding principal amount of the Term Loan shall be reserved against the Revolving Line which would otherwise be available to Borrower as set forth above.

**2.2 Overadvances.** If at any time or for any reason the total of all outstanding Advances and all other monetary Obligations exceeds Net Borrowing Availability (an **"Overadvance"**), Borrower shall immediately pay the amount of the excess to Bank, without notice or demand. Without limiting Borrower's obligation to repay to Bank the amount of any Overadvance, Borrower agrees to pay Bank interest on the outstanding amount of any Overadvance, on demand, at the Default Rate.

## 2.3 Payment of Interest on the Credit Extensions.

(a) Interest Rate.

(i) Advances. Subject to Section 2.3(b), the principal amount outstanding under the Revolving Line shall accrue interest at a floating per annum rate equal to 1.25% percentage points above the Prime Rate, provided that the interest rate in effect on any given day shall not be less than 8.50% per annum, which interest shall be payable monthly.

(ii) Term Loan. Subject to Section 2.3(b), the principal amount outstanding under the Term Loan shall accrue interest at a floating per annum rate equal to 1.25% percentage points above the Prime Rate, provided that the interest rate in effect on any given day shall not be less than 8.50% per annum, which interest shall be payable monthly.

(b) Default Rate. Immediately upon the occurrence and during the continuance of an Event of Default, Obligations shall bear interest at a rate per annum which is five percentage points above the rate effective immediately before the Event of Default (the "**Default Rate**"). Payment or acceptance of the increased interest rate provided in this Section 2.3(b) is not a permitted alternative to timely payment and shall not constitute a waiver of any Event of Default or otherwise prejudice or limit any rights or remedies of Bank.

(c) Adjustment to Interest Rate. Changes to the interest rate of any Credit Extension based on changes to the Prime Rate shall be effective on the effective date of any change to the Prime Rate and to the extent of any such change.

(d) 360-Day Year. Interest shall be computed on the basis of a 360-day year for the actual number of days elapsed.

(e) Debit of Accounts. Bank may debit any of Borrower's deposit accounts, including the Designated Deposit Account, for principal and interest payments or any other amounts Borrower owes Bank when due. These debits shall not constitute a set-off.

(f) Minimum Monthly Interest. [omitted].

(g) Payment; Interest Computation; Float Charge. Interest is payable monthly on the last calendar day of each month. In computing interest on the Obligations, all payments received after 12:00 p.m. Pacific time on any day shall be deemed received on the next Business Day. In addition, so long as any principal or interest with respect to any Credit Extension remains outstanding, Bank shall be entitled to charge Borrower a "float" charge in an amount equal to three (3) Business Days interest, at the interest rate applicable to the Advances, on all payments received by Bank. Said float charge is not included in interest for purposes of computing Minimum Monthly Interest (if any) under this Agreement. The float charge for each month shall be payable on the last day of the month. Bank shall not, however, be required to credit Borrower's account for the amount of any item of payment which is unsatisfactory to Bank in its good faith business judgment, and Bank may charge Borrower's Designated Deposit Account for the amount of any item of payment which is returned to Bank unpaid.

## 2.4 Fees. Borrower shall pay to Bank:

(a) Commitment Fee. A fully earned, non-refundable commitment fee of \$40,000, on the Effective Date (less the amount of \$13,608 which Bank acknowledges it has already been received from Borrower); and

(b) Letter of Credit Fee. Bank's customary fees and expenses for the issuance or renewal of Letters of Credit upon the issuance or renewal of such Letter of Credit by Bank; and

(c) Termination Fee. Subject to the terms of Section 4.1, a termination fee as set forth in Section 4.1; and

(d) Unused Revolving Line Facility Fee. A fee (the "**Unused Revolving Line Facility Fee**"), which fee shall be paid monthly, in arrears, on a calendar year basis, in an amount equal to 0.25% per annum of the average unused portion of the Revolving Line, as determined by Bank. Borrower shall not be entitled to any credit, rebate or repayment of any Unused Revolving Line Facility Fee previously earned by Bank pursuant to this Section notwithstanding any termination of the Agreement, or suspension or termination of Bank's obligation to make loans and advances hereunder, including during any Streamline Period; and

(e) Collateral Monitoring Fee. A monthly collateral monitoring fee of \$2,000, payable in arrears on the last day of each month (prorated for any partial month at the beginning and upon termination of this Agreement); and

(f) Bank Expenses. All Bank Expenses (including reasonable attorneys' fees and expenses, and expenses for documentation and negotiation of this Agreement) incurred through and after the Effective Date, when due; and

(g) Anniversary Fee. A fully earned, non-refundable anniversary fee of \$40,000, on the first anniversary of the Effective Date.

### **3 CONDITIONS OF LOANS**

**3.1 Conditions Precedent to Initial Credit Extension.** Bank's obligation to make the initial Credit Extension is subject to the condition precedent that Bank shall have received, in form and substance satisfactory to Bank, such documents, and completion of such other matters, as Bank may reasonably deem necessary or appropriate, including, without limitation:

(a) Borrower shall have delivered duly executed original signatures to the Loan Documents to which it is a party;

(b) Borrower shall have delivered duly executed original signatures to the Control Agreements;

(c) Borrower shall have delivered its Operating Documents and a good standing certificate of Borrower certified by the Secretary of State of the State of Delaware as of a date no earlier than thirty (30) days prior to the Effective Date;

(d) Borrower shall have delivered duly executed original signatures to the completed Borrowing Resolutions for Borrower;

(e) Borrower shall have delivered a Payment Agreement from Wells Fargo Bank;

(f) Borrower shall have delivered evidence that (i) the Liens securing Indebtedness owed by Borrower to Wells Fargo Bank will be terminated and (ii) the documents and/or filings evidencing the perfection of such Liens, including without limitation any financing statements and/or control agreements, have or will, concurrently with the initial Credit Extension, be terminated.

(g) Bank shall have received certified copies, dated as of a recent date, of financing statement searches, as Bank shall request, accompanied by written evidence (including any UCC termination statements) that the Liens indicated in any such financing statements either constitute Permitted Liens or have been or, in connection with the initial Credit Extension, will be terminated or released;

(h) Borrower shall have delivered the Perfection Certificate(s) executed by Borrower;

(i) [omitted];

(j) Borrower shall have delivered the insurance policies and/or endorsements required pursuant to Section 6.5 hereof; and

(k) Borrower shall have paid the fees and Bank Expenses then due as specified in Section 2.4 hereof.

**3.2 Conditions Precedent to all Credit Extensions.** Bank's obligations to make each Credit Extension, including the initial Credit Extension, is subject to the following:

(a) except as otherwise provided in Section 3.4(a), timely receipt of an executed Payment/Advance Form or Transaction Report, as applicable;

(b) the representations and warranties in Section 5 shall be true in all material respects on the date of the Payment/Advance Form or Transaction Report, as applicable, and on the Funding Date of each Credit Extension; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, and no Default or Event of Default shall have occurred and be continuing or result from the Credit Extension. Each Credit Extension is Borrower's representation and warranty on that date that the representations and warranties in Section 5 remain true in all material respects; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date; and

(c) in Bank's sole discretion, there has not been a Material Adverse Change.

### **3.3 Covenant to Deliver.**

Borrower agrees to deliver to Bank each item required to be delivered to Bank under this Agreement as a condition to any Credit Extension. Borrower expressly agrees that the extension of a Credit Extension prior to the receipt by Bank of any such item shall not constitute a waiver by Bank of Borrower's obligation to deliver such item, and any such extension in the absence of a required item shall be in Bank's sole discretion.

### **3.4 Procedures for Borrowing.**

(a) Advances. Subject to the prior satisfaction of all other applicable conditions to the making of an Advance set forth in this Agreement, to obtain an Advance, Borrower shall notify Bank (which notice shall be irrevocable) by electronic mail, facsimile, or telephone by 12:00 p.m. Pacific time on the Funding Date of the Advance. Together with such notification, Borrower must promptly deliver to Bank by electronic mail or facsimile a completed Transaction Report executed by a Responsible Officer or his or her designee. Bank shall credit Advances to the Designated Deposit Account. Bank may make Advances under this Agreement based on instructions from a Responsible Officer or his or her designee or without instructions if the Advances are necessary to meet Obligations that have become due. Bank may rely on any telephone notice given by a person whom Bank believes is a Responsible Officer or designee.

(b) Term loan. Subject to the prior satisfaction of all other applicable conditions to the making of the Term Loan set forth in this Agreement, if any portion of the proceeds of the Term Loan shall be used to purchase or finance Equipment, Borrower shall deliver to Bank by electronic mail or facsimile a copy of the invoice for the Equipment to be purchased and/or refinanced and the request for the Term Loan.

## **4 CREATION OF SECURITY INTEREST**

**4.1 Grant of Security Interest.** Borrower hereby grants Bank, to secure the payment and performance in full of all of the Obligations, a continuing security interest in, and pledges to Bank, the Collateral, wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof. Borrower represents, warrants, and covenants that the security interest granted herein is and shall at all times continue to be a first priority perfected security interest in the Collateral (subject only to Permitted Liens that may have superior priority to Bank's Lien under this Agreement). If Borrower shall acquire a commercial tort claim, Borrower shall promptly notify Bank in a writing signed by Borrower of the general details thereof and grant to Bank in such writing a security interest therein and in the proceeds thereof, all upon the terms of this Agreement, with such writing to be in form and substance reasonably satisfactory to Bank.

This Agreement may be terminated prior to the Revolving Line Maturity Date by Borrower, effective three (3) Business Days after written notice of termination is given to Bank or if Bank's obligation to fund Credit Extensions terminates pursuant to the terms of Section 2.1.1(c). Notwithstanding any such termination, Bank's lien and security interest in the Collateral shall continue until Borrower fully satisfies its Obligations. If such termination is at Borrower's election or at Bank's election due to the occurrence and continuance of an Event of Default, Borrower shall pay to Bank, in addition to the payment of any other expenses or fees then-owing, a termination fee in an amount equal to 2.0% of the Maximum Dollar Amount if termination occurs on or before the first anniversary of the Effective Date, and 1.0% of the Maximum Dollar Amount if termination occurs after the first anniversary of the Effective Date; provided that no termination fee shall be charged if the credit facility hereunder is



replaced with a new facility from a division of Silicon Valley Bank. Upon payment in full of the Obligations and at such time as Bank's obligation to make Credit Extensions has terminated, Bank shall release its liens and security interests in the Collateral and all rights therein shall revert to Borrower.

**4.2 Authorization to File Financing Statements.** Borrower hereby authorizes Bank to file financing statements, without notice to Borrower, with all appropriate jurisdictions to perfect or protect Bank's interest or rights hereunder, including a notice that any disposition of the Collateral, by either Borrower or any other Person, shall be deemed to violate the rights of Bank under the Code.

## **5 REPRESENTATIONS AND WARRANTIES**

Borrower represents and warrants as follows:

**5.1 Due Organization and Authorization.** Borrower and each of its Subsidiaries are duly existing and in good standing in their respective jurisdictions of formation and are qualified and licensed to do business and are in good standing in any jurisdiction in which the conduct of their business or their ownership of property requires that they be qualified except where the failure to do so could not reasonably be expected to have a Material Adverse Change. In connection with this Agreement, Borrower has delivered to Bank a completed certificate signed by Borrower entitled "Perfection Certificate". Borrower represents and warrants to Bank that (a) Borrower's exact legal name is that indicated on the Perfection Certificate and on the signature page hereof; (b) Borrower is an organization of the type and is organized in the jurisdiction set forth in the Perfection Certificate; (c) the Perfection Certificate accurately sets forth Borrower's organizational identification number or accurately states that Borrower has none; (d) the Perfection Certificate accurately sets forth Borrower's place of business, or, if more than one, its chief executive office as well as Borrower's mailing address (if different than its chief executive office); (e) Borrower (and each of its predecessors) has not, in the past five (5) years, changed its jurisdiction of formation, organizational structure or type, or any organizational number assigned by its jurisdiction; and (f) all other information set forth on the Perfection Certificate pertaining to Borrower and each of its Subsidiaries is accurate and complete. If Borrower is not now a Registered Organization but later becomes one, Borrower shall promptly notify Bank of such occurrence and provide Bank with Borrower's organizational identification number.

The execution, delivery and performance of the Loan Documents have been duly authorized, and do not conflict with Borrower's organizational documents, nor constitute an event of default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement to which it is a party or by which it is bound in which the default could reasonably be expected to cause a Material Adverse Change.

**5.2 Collateral.** Borrower has good title to the Collateral, free of Liens except Permitted Liens. Borrower has no deposit account other than the deposit accounts with Bank and deposit accounts described in the Perfection Certificate delivered to Bank in connection herewith.

The Collateral is not in the possession of any third party bailee (such as a warehouse). Except as hereafter disclosed to Bank in writing by Borrower, none of the components of the Collateral shall be maintained at locations other than as provided in the Perfection Certificate. In the event that Borrower, after the date hereof, intends to store or otherwise deliver any portion of the Collateral to a bailee, then Borrower will first receive the written consent of Bank and such bailee must acknowledge in writing that the bailee is holding such Collateral for the benefit of Bank.

All Inventory is in all material respects of good and marketable quality, free from material defects.

Borrower is the sole owner of its Intellectual Property, except for non-exclusive licenses granted to its customers in the ordinary course of business. Each Patent is valid and enforceable and no part of the Intellectual Property has been judged invalid or unenforceable, in whole or in part, and to the best of Borrower's knowledge, no claim has been made that any part of the Intellectual Property violates the rights of any third party except to the extent such claim could not reasonably be expected to cause a Material Adverse Change.

Except as noted on the Perfection Certificate, Borrower is not a party to, nor is bound by, any material license or other agreement with respect to which Borrower is the licensee that prohibits or otherwise restricts Borrower from granting a security interest in Borrower's interest in such license or agreement or any other property. Borrower shall provide written notice to Bank within thirty days of entering or becoming bound by any such license or agreement which is reasonably likely to have a material impact on Borrower's business or financial condition.

(other than over-the-counter software that is commercially available to the public). Borrower shall take such steps as Bank requests to obtain the consent of, or waiver by, any person whose consent or waiver is necessary for all such licenses or contract rights to be deemed “Collateral” and for Bank to have a security interest in it that might otherwise be restricted or prohibited by law or by the terms of any such license or agreement (such consent or authorization may include a licensor’s agreement to a contingent assignment of the license to Bank if Bank determines that is necessary in its good faith judgment), whether now existing or entered into in the future.

### **5.3 Accounts Receivable.**

(a) For each Account with respect to which Advances are requested, on the date each Advance is requested and made, such Account shall be an Eligible Account, set forth in Section 13 below.

(b) All statements made and all unpaid balances appearing in all invoices, instruments and other documents evidencing the Accounts are and shall be true and correct and all such invoices, instruments and other documents, and all of Borrower’s Books are genuine and in all respects what they purport to be. All sales and other transactions underlying or giving rise to each Account shall comply in all material respects with all applicable laws and governmental rules and regulations. Borrower has and will have no knowledge of any actual or imminent Insolvency Proceeding of any Account Debtor whose accounts are shown as Eligible Accounts in any Transaction Report. To the best of Borrower’s knowledge, all signatures and endorsements on all documents, instruments, and agreements relating to all Accounts are and will be genuine, and all such documents, instruments and agreements are and will be legally enforceable in accordance with their terms.

**5.4 Litigation.** There are no actions or proceedings pending or, to the knowledge of the Responsible Officers, threatened in writing by or against Borrower or any of its Subsidiaries involving more than \$50,000.

**5.5 No Material Deviation in Financial Statements.** All consolidated financial statements for Borrower and any of its Subsidiaries delivered to Bank fairly present in all material respects Borrower’s consolidated financial condition and Borrower’s consolidated results of operations. There has not been any material deterioration in Borrower’s consolidated financial condition since the date of the most recent financial statements submitted to Bank.

**5.6 Solvency.** Borrower is able to pay its debts (including trade debts) as they mature.

**5.7 Regulatory Compliance.** Borrower is not an “investment company” or a company “controlled” by an “investment company” under the Investment Company Act. Borrower is not engaged as one of its important activities in extending credit for margin stock (under Regulations T and U of the Federal Reserve Board of Governors). Borrower has complied in all material respects with the Federal Fair Labor Standards Act. Borrower has not violated any laws, ordinances or rules, the violation of which could reasonably be expected to cause a Material Adverse Change. None of Borrower’s or any of its Subsidiaries’ properties or assets has been used by Borrower or any Subsidiary or, to the best of Borrower’s knowledge, by previous Persons, in disposing, producing, storing, treating, or transporting any hazardous substance other than legally. Borrower and each of its Subsidiaries have obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all notices to, all government authorities that are necessary to continue its business as currently conducted.

**5.8 Subsidiaries; Investments.** Borrower does not have any Subsidiaries, other than Iteris Europe GmbH and other Subsidiaries organized with the prior written consent of Bank, and does not own any stock, partnership interest or other equity securities in any other Person, except for Permitted Investments.

**5.9 Tax Returns and Payments; Pension Contributions.** Borrower has timely filed all required tax returns and reports, and Borrower has timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower. Borrower may defer payment of any contested taxes, provided that Borrower (a) in good faith contests its obligation to pay the taxes by appropriate proceedings promptly and diligently instituted and conducted, (b) notifies Bank in writing of the commencement of, and any material development in, the proceedings, (c) posts bonds or takes any other steps required to prevent the governmental authority levying such contested taxes from obtaining a Lien upon any of the Collateral that is other than a “Permitted Lien”. Borrower is unaware of any claims or adjustments proposed for any of Borrower’s prior tax years which could result in additional taxes becoming due and payable by Borrower. Borrower has paid all amounts necessary to fund all present pension, profit sharing and deferred compensation plans in accordance with their terms, and Borrower has not withdrawn from participation in, and has not permitted partial or complete termination of, or permitted the occurrence of any other event with respect to, any such plan which could reasonably be expected to result in any

liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other governmental agency.

**5.10 Use of Proceeds.** Borrower shall use the proceeds of the Credit Extensions solely as working capital, and to fund its general business requirements and not for personal, family, household or agricultural purposes.

**5.11 Full Disclosure.** No written representation, warranty or other statement of Borrower in any certificate or written statement given to Bank, as of the date such representations, warranties, or other statements were made, taken together with all such written certificates and written statements given to Bank, contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained in the certificates or statements not misleading (it being recognized by Bank that the projections and forecasts provided by Borrower in good faith and based upon reasonable assumptions are not viewed as facts and that actual results during the period or periods covered by such projections and forecasts may differ from the projected or forecasted results).

## **6 AFFIRMATIVE COVENANTS**

Borrower shall do all of the following:

**6.1 Government Compliance.** Maintain its and all its Subsidiaries' legal existence and good standing in their respective jurisdictions of formation and maintain qualification in each jurisdiction in which the failure to so qualify would reasonably be expected to cause a Material Adverse Change. Borrower shall comply, and have each Subsidiary comply, with all laws, ordinances and regulations to which it is subject, noncompliance with which could reasonably be expected to cause a Material Adverse Change.

### **6.2 Financial Statements, Reports, Certificates.**

- (a) Borrower shall provide Bank with the following:
  - (i) a Transaction Report weekly and at the time of each request for an Advance;
  - (ii) within fifteen (15) days after the end of each month,
    - (A) monthly accounts receivable agings, aged by invoice date,
    - (B) monthly accounts payable agings, aged by invoice date, and outstanding or held check registers, if any,
    - (C) monthly reconciliations of accounts receivable agings (aged by invoice date), transaction reports, and general ledger,
    - (D) monthly perpetual inventory reports for Inventory valued on a first-in, first-out basis at the lower of cost or market (in accordance with GAAP) or such other inventory reports as are requested by Bank in its good faith business judgment;
  - (iii) as soon as available, and in any event within thirty (30) days after the end of each month, monthly unaudited financial statements;
  - (iv) within thirty (30) days after the end of each month a monthly Compliance Certificate signed by a Responsible Officer, certifying that as of the end of such month, Borrower was in full compliance with all of the terms and conditions of this Agreement, and setting forth calculations showing compliance with the financial covenants set forth in this Agreement and such other information as Bank shall reasonably request, including, without limitation, a statement that at the end of such month there were no held checks;
  - (v) [omitted];
  - (vi) within thirty (30) days prior to the end of each fiscal year of Borrower, (A) annual operating budgets (including income statements, balance sheets and cash flow statements, by month) for the upcoming fiscal year of Borrower, and (B)

annual financial projections for the following fiscal year (on a quarterly basis) as approved by Borrower's board of directors, together with any related business forecasts used in the preparation of such annual financial projections; and

(vii) [omitted].

(b) At all times that Borrower is subject to the reporting requirements under the Securities Exchange Act of 1934, as amended, within five (5) days after filing, all reports on Form 10-K, 10-Q and 8-K filed with the Securities and Exchange Commission or a link thereto on Borrower's or another website on the Internet.

(c) Prompt written notice of (i) any material change in the composition of the Intellectual Property, (ii) the registration of any Copyright, including any subsequent ownership right of Borrower in or to any Copyright, Patent or Trademark not shown in the IP Security Agreement, or (iii) Borrower's knowledge of an event that materially adversely affects the value of the Intellectual Property.

### **6.3 Accounts Receivable.**

(a) Schedules and Documents Relating to Accounts. Borrower shall deliver to Bank transaction reports and schedules of collections, as provided in Section 6.2, on Bank's standard forms; provided, however, that Borrower's failure to execute and deliver the same shall not affect or limit Bank's Lien and other rights in all of Borrower's Accounts, nor shall Bank's failure to advance or lend against a specific Account affect or limit Bank's Lien and other rights therein. If requested by Bank, Borrower shall furnish Bank with copies (or, at Bank's request, originals) of all contracts, orders, invoices, and other similar documents, and all shipping instructions, delivery receipts, bills of lading, and other evidence of delivery, for any goods the sale or disposition of which gave rise to such Accounts. In addition, Borrower shall deliver to Bank, on its request, the originals of all instruments, chattel paper, security agreements, guarantees and other documents and property evidencing or securing any Accounts, in the same form as received, with all necessary endorsements, and copies of all credit memos.

(b) Disputes. Borrower shall promptly notify Bank of all disputes or claims in excess of \$15,000 relating to Accounts. Borrower may forgive (completely or partially), compromise, or settle any Account for less than payment in full, or agree to do any of the foregoing so long as (i) Borrower does so in good faith, in a commercially reasonable manner, in the ordinary course of business, in arm's-length transactions, and reports the same to Bank in the regular reports provided to Bank; and (ii) no Default or Event of Default has occurred and is continuing; and (iii) after taking into account all such discounts, settlements and forgiveness, the total outstanding Advances will not exceed the lesser of the Revolving Line or the Borrowing Base.

(c) Collection of Accounts. Borrower shall have the right to collect all Accounts, unless and until a Default or an Event of Default has occurred and is continuing. Whether or not an Event of Default has occurred and is continuing, Borrower shall hold all payments on, and proceeds of, Accounts in trust for Bank, and Borrower shall immediately deliver all such payments and proceeds to Bank in their original form, duly endorsed, to be applied to the Obligations pursuant to the terms of Section 9.4 hereof. Bank may, in its good faith business judgment, require that all proceeds of Accounts be deposited by Borrower into a lockbox account, or such other "blocked account" as Bank may specify, pursuant to a blocked account agreement in such form as Bank may specify in its good faith business judgment.

(d) Returns. Provided no Event of Default has occurred and is continuing, if any Account Debtor returns any Inventory to Borrower, Borrower shall promptly (i) determine the reason for such return, (ii) issue a credit memorandum to the Account Debtor in the appropriate amount, and (iii) provide a copy of such credit memorandum to Bank, upon request from Bank. In the event any attempted return occurs after the occurrence and during the continuance of any Event of Default, Borrower shall hold the returned Inventory in trust for Bank, and immediately notify Bank of the return of the Inventory.

(e) Verification. Bank may, from time to time, upon prior notice to Borrower (via an invoice copy request or otherwise) verify directly with the respective Account Debtors the validity, amount and other matters relating to the Accounts, either in the name of Borrower or Bank or such other name as Bank may choose; provided, however, the Bank shall not incur any liability for inadvertently or negligently failing to provide such notice.

(f) **No Liability.** Bank shall not be responsible or liable for any shortage or discrepancy in, damage to, or loss or destruction of, any goods, the sale or other disposition of which gives rise to an Account, or for any error, act, omission, or delay of any kind occurring in the settlement, failure to settle, collection or failure to collect any Account, or for settling any Account in good faith for less than the full amount thereof, nor shall Bank be deemed to be responsible for any of Borrower's obligations under any contract or agreement giving rise to an Account. Nothing herein shall, however, relieve Bank from liability for its own gross negligence or willful misconduct.

**6.4 Remittance of Proceeds.** Except as otherwise provided in Section 6.3(c), deliver, in kind, all proceeds arising from the disposition of any Collateral to Bank in the original form in which received by Borrower not later than the following Business Day after receipt by Borrower, to be applied to the Obligations pursuant to the terms of Section 9.4 hereof; provided that, if no Default or Event of Default has occurred and is continuing, Borrower shall not be obligated to remit to Bank the proceeds of the sale of worn out or obsolete Equipment disposed of by Borrower in good faith in an arm's length transaction for an aggregate purchase price of \$25,000 or less (for all such transactions in any fiscal year). Borrower agrees that it will not commingle proceeds of Collateral with any of Borrower's other funds or property, but will hold such proceeds separate and apart from such other funds and property and in an express trust for Bank. Nothing in this Section limits the restrictions on disposition of Collateral set forth elsewhere in this Agreement.

**6.5 Taxes; Pensions.** Timely file all required tax returns and reports and timely pay all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower except for deferred payment of any taxes contested pursuant to the terms of Section 5.9 hereof, and pay all amounts necessary to fund all present pension, profit sharing and deferred compensation plans in accordance with their terms.

**6.6 Access to Collateral; Books and Records.** At reasonable times, on one (1) Business Day's notice (provided no notice is required if an Event of Default has occurred and is continuing), Bank, or its agents, shall have the right to inspect the Collateral and the right to audit and copy Borrower's Books. The parties contemplate that such audits will be performed no more frequently than three times per calendar year, but nothing herein restricts Bank's right to conduct such audits more frequently if (i) Bank believes that it is advisable to do so in Bank's good faith business judgment, or (ii) Bank believes in good faith that a Default or Event of Default has occurred and is continuing; provided, however, that Borrower will not be responsible for the expense of any more than three (3) audits in any calendar year (other than audits performed when a Default or Event of Default has occurred and is continuing). The foregoing inspections and audits shall be at Borrower's expense, and the charge therefor shall be \$750 per person per day (or such higher amount as shall represent Bank's then-current standard charge for the same), plus reasonable out-of-pocket expenses. In the event Borrower and Bank schedule an audit more than ten (10) days in advance, and Borrower cancels or seeks to reschedule the audit with less than ten (10) days written notice to Bank, then (without limiting any of Bank's rights or remedies), Borrower shall pay Bank a fee of \$1,000 plus any out-of-pocket expenses incurred by Bank to compensate Bank for the anticipated costs and expenses of the cancellation or rescheduling.

**6.7 Insurance.** Keep its business and the Collateral insured for risks and in amounts standard for companies in Borrower's industry and location and as Bank may reasonably request. Insurance policies shall be in a form, with companies, and in amounts that are satisfactory to Bank. All property policies shall have a lender's loss payable endorsement showing Bank as an additional lender loss payee and waive subrogation against Bank, and all liability policies shall show, or have endorsements showing, Bank as an additional insured. All policies (or the loss payable and additional insured endorsements) shall provide that the insurer must give Bank at least twenty (20) days notice before canceling, amending, or declining to renew its policy. At Bank's request, Borrower shall deliver certified copies of policies and evidence of all premium payments. Proceeds payable under any policy shall, at Bank's option, be payable to Bank on account of the Obligations. Notwithstanding the foregoing, (a) so long as no Event of Default has occurred and is continuing, Borrower shall have the option of applying the proceeds of any casualty policy up to \$50,000, in the aggregate, toward the replacement or repair of destroyed or damaged property; provided that any such replaced or repaired property (i) shall be of equal or like value as the replaced or repaired Collateral and (ii) shall be deemed Collateral in which Bank has been granted a first priority security interest, and (b) after the occurrence and during the continuance of an Event of Default, all proceeds payable under such casualty policy shall, at the option of Bank, be payable to Bank on account of the Obligations. If Borrower fails to obtain insurance as required under this Section 6.7 or to pay any amount or furnish any required proof of payment to third persons and Bank, Bank may make all or part of such payment or obtain such insurance policies required in this Section 6.7, and take any action under the policies Bank deems prudent.

## **6.8 Operating Accounts.**

(a) Maintain its and its Subsidiaries' primary depository and operating accounts and securities accounts maintained in the United States with Bank and Bank's affiliates which accounts shall represent at least 85% of the dollar value of Borrower's and such Subsidiaries accounts at all financial institutions.

(b) Disclose in writing to Bank all Collateral Accounts maintained with any bank or financial institution other than Bank or its Affiliates. In addition, for each Collateral Account that Borrower maintains with any bank or financial institution other than Bank or its Affiliates, Borrower shall cause the deposits and/or securities maintained therein to be transferred to Bank or its Affiliates within 90 days of the Effective Date and for any deposits and/or securities not so transferred to Bank and its Affiliates within such time period, Borrower shall cause such applicable bank or financial institution (other than Bank) at or with which any Collateral Account is maintained to execute and deliver a Control Agreement or other appropriate instrument with respect to such Collateral Account to perfect Bank's Lien in such Collateral Account in accordance with the terms hereunder. The provisions of the previous sentence shall not apply to deposit accounts exclusively used for payroll, payroll taxes and other employee wage and benefit payments to or for the benefit of Borrower's employees and identified to Bank by Borrower as such.

## **6.9 Financial Covenants.**

Borrower shall maintain at all times, to be tested as of the last day of each month, unless otherwise noted, on a consolidated basis:

(a) Tangible Net Worth. A Tangible Net Worth of at least **\$4,000,000 ("Minimum Tangible Net Worth")** plus (i) 25% of all consideration received after the date hereof for equity securities and subordinated debt of the Borrower, plus (ii) 25% of the Borrower's net income in each fiscal quarter ending after the date hereof. Increases in the Minimum Tangible Net Worth based on consideration received for equity securities and subordinated debt of the Borrower shall be effective as of the end of the month in which such consideration is received, and shall continue effective thereafter. Increases in the Minimum Tangible Net Worth based on net income shall be effective on the last day of the fiscal quarter in which said net income is realized, and shall continue effective thereafter. In no event shall the Minimum Tangible Net Worth be decreased.

**6.10 Intellectual Property Rights.** Borrower shall: (a) protect, defend and maintain the validity and enforceability of its intellectual property; (b) promptly advise Bank in writing of material infringements of its intellectual property; and (c) not allow any intellectual property material to Borrower's business to be abandoned, forfeited or dedicated to the public without Bank's written consent. If Borrower decides to register any copyrights or mask works in the United States Copyright Office, Borrower shall: (x) provide Bank with at least fifteen (15) days prior written notice of its intent to register such copyrights or mask works together with a copy of the application it intends to file with the United States Copyright Office (excluding exhibits thereto); (y) execute an intellectual property security agreement or such other documents as Bank may reasonably request to maintain the perfection and priority of Bank's security interest in the copyrights or mask works intended to be registered with the United States Copyright Office; and (z) record such intellectual property security agreement with the United States Copyright Office contemporaneously with filing the copyright or mask work application(s) with the United States Copyright Office. Borrower shall promptly provide to Bank a copy of the application(s) filed with the United States Copyright Office together with evidence of the recording of the intellectual property security agreement necessary for Bank to maintain the perfection and priority of its security interest in such copyrights or mask works. Borrower shall provide written notice to Bank of any application filed by Borrower in the United States Patent and Trademark Office for a patent or to register a trademark or service mark within 30 days after any such filing.

**6.11 Litigation Cooperation.** From the date hereof and continuing through the termination of this Agreement, make available to Bank, without expense to Bank, Borrower and its officers, employees and agents and Borrower's books and records, to the extent that Bank may deem them reasonably necessary to prosecute or defend any third-party suit or proceeding instituted by or against Bank with respect to any Collateral or relating to Borrower.

## **6.12 [omitted]**

**6.13 Further Assurances.** Borrower shall execute any further instruments and take further action as Bank reasonably requests to perfect or continue Bank's Lien in the Collateral or to effect the purposes of this Agreement.

## **7 NEGATIVE COVENANTS**

Borrower shall not do any of the following without Bank's prior written consent:

**7.1 Dispositions.** Convey, sell, lease, transfer or otherwise dispose of (collectively, "**Transfer**"), or permit any of its Subsidiaries to Transfer, all or any part of its business or property, except for (a) Transfers of Inventory in the ordinary course of business; (b) Transfers of worn-out or obsolete Equipment; and (c) Transfers consisting of Permitted Liens and Permitted Investments.

### **7.2 Changes in Business, Management, Ownership, or Business Locations.**

(a) Engage in or permit any of its Subsidiaries to engage in any business other than the businesses currently engaged in by Borrower and such Subsidiary, as applicable, or reasonably related thereto;

(b) liquidate or dissolve; or

(c) permit any person or two or more persons acting in concert from acquiring beneficial ownership (within the meaning of Rule 13(d) (3) of the Securities and Exchange Commission under the Securities Exchange Act of 1934), directly or indirectly, of shares of stock of the Borrower representing more than 50% of the combined voting power of all shares of stock of the Borrower entitled to vote in the election of directors (other than by the sale of Borrower's equity securities in a public offering or to venture capital investors so long as Borrower identifies to Bank the venture capital investors prior to the closing of the transaction); or

(d) without at least thirty (30) days prior written notice to Bank: (1) add any new offices or business locations, including warehouses (unless such new offices or business locations contain assets and property of Borrower with an aggregate value of less than \$10,000), (2) change its jurisdiction of organization, (3) change its organizational structure or type, (4) change its legal name, or (5) change its organizational number (if any) assigned by its jurisdiction of organization.

**7.3 Mergers or Acquisitions.** Merge or consolidate, or permit any of its Subsidiaries to merge or consolidate, with any other Person, or acquire, or permit any of its Subsidiaries to acquire, all or substantially all of the capital stock or property of another Person, except that a Subsidiary of Borrower may merge or consolidate into another Subsidiary of Borrower or into Borrower.

**7.4 Indebtedness.** Create, incur, assume, or be liable for any Indebtedness, or permit any Subsidiary to do so, other than Permitted Indebtedness.

**7.5 Encumbrance.** Create, incur, or allow any Lien on any of its property or assets, or assign or convey any right to receive income, including the sale of any Accounts, or permit any of its Subsidiaries to do so, except for Permitted Liens, or permit any Collateral not to be subject to the first priority security interest granted herein (except as otherwise specifically allowed in the definition of Permitted Liens), or enter into any agreement, document, instrument or other arrangement (except with or in favor of Bank) with any Person which directly or indirectly prohibits or has the effect of prohibiting Borrower or any Subsidiary from assigning, mortgaging, pledging, granting a security interest in or upon, or encumbering any of Borrower's or any Subsidiary's intellectual property, except as is otherwise permitted in Section 7.1 hereof and the definition of "Permitted Lien" herein.

**7.6 Maintenance of Collateral Accounts.** Maintain any Collateral Account except pursuant to the terms of Section 6.8.(b) hereof.

**7.7 Investments; Distributions.** (a) Directly or indirectly make any Investment other than Permitted Investments, or permit any of its Subsidiaries to do so; or (b) pay any dividends or make any distribution or payment or redeem, retire or purchase any capital stock, provided that (i) Borrower may convert any of its convertible securities into other securities pursuant to the terms of such convertible securities or otherwise in exchange thereof, (ii) Borrower may pay dividends solely in common stock; and (iii) Borrower may repurchase the stock of former

employees or consultants pursuant to stock repurchase agreements so long as no Default or Event of Default has occurred at the time of such repurchase and would not exist after giving effect to such repurchase, provided such repurchase does not exceed in the aggregate of \$50,000 per fiscal year.

**7.8 Transactions with Affiliates.** Directly or indirectly enter into or permit to exist any material transaction with any Affiliate of Borrower, except for transactions that are in the ordinary course of Borrower's business, upon fair and reasonable terms that are no less favorable to Borrower than would be obtained in an arm's length transaction with a non-affiliated Person.

**7.9 Subordinated Debt.** (a) Make or permit any payment on any Subordinated Debt, except under the terms of the subordination, intercreditor, or other similar agreement to which such Subordinated Debt is subject, or (b) amend any provision in any document relating to the Subordinated Debt which would increase the amount thereof or the amount of any permitted payments thereunder or adversely affect the subordination thereof to Obligations owed to Bank.

**7.10 Compliance.** Become an "investment company" or a company controlled by an "investment company", under the Investment Company Act of 1940 or undertake as one of its important activities extending credit to purchase or carry margin stock (as defined in Regulation U of the Board of Governors of the Federal Reserve System), or use the proceeds of any Credit Extension for that purpose; fail to meet the minimum funding requirements of ERISA, permit a Reportable Event or Prohibited Transaction, as defined in ERISA, to occur; fail to comply with the Federal Fair Labor Standards Act or violate any other law or regulation, if the violation could reasonably be expected to cause a Material Adverse Change, or permit any of its Subsidiaries to do so; withdraw or permit any Subsidiary to withdraw from participation in, permit partial or complete termination of, or permit the occurrence of any other event with respect to, any present pension, profit sharing and deferred compensation plan which could reasonably be expected to result in any liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other governmental agency.

## **8 EVENTS OF DEFAULT**

Any one of the following shall constitute an event of default (an "**Event of Default**") under this Agreement:

**8.1 Payment Default.** Borrower fails to (a) make any payment of principal or interest on any Credit Extension on its due date, or (b) pay any other Obligations within three (3) Business Days after such Obligations are due and payable. During the cure period, the failure to cure the payment default is not an Event of Default (but no Credit Extension will be made during the cure period);

### **8.2 Covenant Default.**

(a) Borrower fails or neglects to perform any obligation in Sections 6.2, 6.3, 6.4, 6.6, 6.8, or 6.9, or violates any covenant in Section 7;  
or

(b) Borrower fails or neglects to perform, keep, or observe any other term, provision, condition, covenant or agreement contained in this Agreement, any Loan Documents, and as to any default (other than those specified in this Section 8) under such other term, provision, condition, covenant or agreement that can be cured, has failed to cure the default within ten (10) days after the occurrence thereof; provided, however, that if the default cannot by its nature be cured within the ten (10) day period or cannot after diligent attempts by Borrower be cured within such ten (10) day period, and such default is likely to be cured within a reasonable time, then Borrower shall have an additional period (which shall not in any case exceed thirty (30) days) to attempt to cure such default, and within such reasonable time period the failure to cure the default shall not be deemed an Event of Default (but no Credit Extensions shall be made during such cure period). Grace periods provided under this section shall not apply, among other things, to financial covenants or any other covenants set forth in subsection (a) above;

**8.3 Material Adverse Change.** A Material Adverse Change occurs;

**8.4 Attachment.** (a) Any material portion of Borrower's assets is attached, seized, levied on, or comes into possession of a trustee or receiver and the attachment, seizure or levy is not removed in ten (10) days; (b) the service of process upon Bank seeking to attach, by trustee or similar process, any funds of Borrower, or any



entity under control of Borrower (including a subsidiary) on deposit with Bank; (c) Borrower is enjoined, restrained, or prevented by court order from conducting a material part of its business; (d) a judgment or other claim in excess of \$10,000 becomes a Lien on any of Borrower's assets; or (e) a notice of lien, levy, or assessment is filed against any of Borrower's assets by any government agency and not paid within ten (10) days after Borrower receives notice. These are not Events of Default if stayed or if a bond is posted pending contest by Borrower within ten days after the date such events occur (but no Credit Extensions shall be made during the cure period);

**8.5 Insolvency.** Borrower is unable to pay its debts (including trade debts) as they become due or otherwise becomes insolvent; (b) Borrower begins an Insolvency Proceeding; or (c) an Insolvency Proceeding is begun against Borrower and not dismissed or stayed within thirty (30) days (but no Credit Extensions shall be made while any of the conditions described in clause (a) exist and/or until any Insolvency Proceeding is dismissed);

**8.6 Other Agreements.** There is a default in any agreement to which Borrower or any Guarantor is a party with a third party or parties resulting in a right by such third party or parties, whether or not exercised, to accelerate the maturity of any Indebtedness in an amount in excess of \$50,000 or that could result in a Material Adverse Change with respect to Borrower's or any Guarantor; provided, however, that the Event of Default under this Section 8.6 caused by the occurrence of a default under such other agreement shall be cured or waived for purposes of this Agreement upon Bank receiving written notice from the party asserting such default of such cure or waiver of the default under such other agreement, if at the time of such cure or waiver under such other agreement (a) Bank has not declared an Event of Default under this Agreement and/or exercised any rights with respect thereto; (b) any such cure or waiver does not result in an Event of Default under any other provision of this Agreement or any Loan Document; and (c) in connection with any such cure or waiver under such other agreement, the terms of any agreement with such third party are not modified or amended in any manner which could in the good faith judgment of Bank be materially less advantageous to Borrower or any Guarantor;

**8.7 Judgments.** A judgment or judgments for the payment of money in an amount, individually or in the aggregate, of \$50,000 or more (not covered by independent third-party insurance) shall be rendered against Borrower and shall remain unsatisfied and unstayed for a period of ten (10) days after the entry thereof (provided that no Credit Extensions will be made prior to the satisfaction or stay of such judgment);

**8.8 Misrepresentations.** Borrower or any Person acting for Borrower makes any representation, warranty, or other statement now or later in this Agreement, any Loan Document or in any writing delivered to Bank or to induce Bank to enter this Agreement or any Loan Document, and such representation, warranty, or other statement is incorrect in any material respect when made;

**8.9 Subordinated Debt.** A default or breach occurs under any agreement between Borrower and any creditor of Borrower that signed a subordination, intercreditor, or other similar agreement with Bank, or any creditor that has signed such an agreement with Bank breaches any terms of such agreement; or

**8.10 Guaranty.** (a) Any guaranty of any Obligations terminates or ceases for any reason to be in full force and effect; (b) any Guarantor does not perform any obligation or covenant under any guaranty of the Obligations; (c) any circumstance described in Sections 8.3, 8.4, 8.5, 8.7, or 8.8. occurs with respect to any Guarantor, or (d) the death, liquidation, winding up, or termination of existence of any Guarantor; or (e) (i) a material impairment in the perfection or priority of Bank's Lien in the collateral provided by Guarantor or in the value of such collateral or (ii) a material adverse change in the general affairs, management, results of operation, condition (financial or otherwise) or the prospect of repayment of the Obligations occurs with respect to any Guarantor.

## **9 BANK'S RIGHTS AND REMEDIES**

**9.1 Rights and Remedies.** If an Event of Default has occurred and is continuing, Bank may, without notice or demand, do any or all of the following:

(a) declare all Obligations immediately due and payable (but if an Event of Default described in Section 8.5 occurs all Obligations are immediately due and payable without any action by Bank);

(b) stop advancing money or extending credit for Borrower's benefit under this Agreement or under any other agreement between Borrower and Bank;

(c) demand that Borrower (i) deposit cash with Bank in an amount equal to the aggregate amount of any Letters of Credit remaining undrawn, as collateral security for the repayment of any future drawings under such Letters of Credit, and Borrower shall forthwith deposit and pay such amounts, and (ii) pay in advance all Letter of Credit fees scheduled to be paid or payable over the remaining term of any Letters of Credit;

(d) terminate any FX Contracts;

(e) demand payment of, and collect any Accounts and General Intangibles comprising Collateral, settle or adjust disputes and claims directly with Account Debtors for amounts, on terms, and in any order that Bank considers advisable, notify any Account Debtor or other Person owing Borrower money of Bank's security interest in such funds, verify the amount of the same and collect the same;

(f) make any payments and do any acts it considers necessary or reasonable to protect the Collateral and/or its security interest in the Collateral. Borrower shall assemble the Collateral if Bank requests and make it available as Bank designates. Bank may enter premises where the Collateral is located, take and maintain possession of any part of the Collateral, and pay, purchase, contest, or compromise any Lien which appears to be prior or superior to its security interest and pay all expenses incurred. Borrower grants Bank a license to enter and occupy any of its premises, without charge, to exercise any of Bank's rights or remedies;

(g) apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Bank owing to or for the credit or the account of Borrower;

(h) ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sale, and sell the Collateral. Bank is hereby granted a non-exclusive, royalty-free license or other right to use, without charge, Borrower's labels, patents, copyrights, mask works, rights of use of any name, trade secrets, trade names, trademarks, service marks, and advertising matter, or any similar property as it pertains to the Collateral, in completing production of, advertising for sale, and selling any Collateral and, in connection with Bank's exercise of its rights under this Section, Borrower's rights under all licenses and all franchise agreements inure to Bank's benefit;

(i) place a "hold" on any account maintained with Bank and/or deliver a notice of exclusive control, any entitlement order, or other directions or instructions pursuant to any Control Agreement or similar agreements providing control of any Collateral;

(j) demand and receive possession of Borrower's Books; and

(k) exercise all rights and remedies available to Bank under the Loan Documents or at law or equity, including all remedies provided under the Code (including disposal of the Collateral pursuant to the terms thereof).

**9.2 Power of Attorney.** Borrower hereby irrevocably appoints Bank as its lawful attorney-in-fact, exercisable upon the occurrence and during the continuance of an Event of Default, to: (a) endorse Borrower's name on any checks or other forms of payment or security; (b) sign Borrower's name on any invoice or bill of lading for any Account or drafts against Account Debtors; (c) settle and adjust disputes and claims about the Accounts directly with Account Debtors, for amounts and on terms Bank determines reasonable; (d) make, settle, and adjust all claims under Borrower's insurance policies; (e) pay, contest or settle any Lien, charge, encumbrance, security interest, and adverse claim in or to the Collateral, or any judgment based thereon, or otherwise take any action to terminate or discharge the same; and (f) transfer the Collateral into the name of Bank or a third party as the Code permits. Borrower hereby appoints Bank as its lawful attorney-in-fact to sign Borrower's name on any documents necessary to perfect or continue the perfection of any security interest regardless of whether an Event of Default has occurred until all Obligations have been satisfied in full and Bank is under no further obligation to make Credit Extensions hereunder. Bank's foregoing appointment as Borrower's attorney in fact, and all of Bank's rights and powers, coupled with an interest, are irrevocable until all Obligations have been fully repaid and performed and Bank's obligation to provide Credit Extensions terminates.

**9.3 Protective Payments.** If Borrower fails to obtain the insurance called for by Section 6.7 or fails to pay any premium thereon or fails to pay any other amount which Borrower is obligated to pay under this Agreement or any other Loan Document, Bank may obtain such insurance or make such payment, and all amounts

so paid by Bank are Bank Expenses and immediately due and payable, bearing interest at the then highest applicable rate, and secured by the Collateral. Bank will make reasonable efforts to provide Borrower with notice of Bank obtaining such insurance at the time it is obtained or within a reasonable time thereafter. No payments by Bank are deemed an agreement to make similar payments in the future or Bank's waiver of any Event of Default.

**9.4 Application of Payments and Proceeds.** Unless an Event of Default has occurred and is continuing, Bank shall apply any funds in its possession, whether from Borrower account balances, payments, or proceeds realized as the result of any collection of Accounts or other disposition of the Collateral, first, to Bank Expenses, including without limitation, the reasonable costs, expenses, liabilities, obligations and attorneys' fees incurred by Bank in the exercise of its rights under this Agreement; second, to the interest due upon any of the Obligations; and third, to the principal of the Obligations and any applicable fees and other charges, in such order as Bank shall determine in its sole discretion. Any surplus shall be paid to Borrower or other Persons legally entitled thereto; Borrower shall remain liable to Bank for any deficiency. If an Event of Default has occurred and is continuing, Bank may apply any funds in its possession, whether from Borrower account balances, payments, proceeds realized as the result of any collection of Accounts or other disposition of the Collateral, or otherwise, to the Obligations in such order as Bank shall determine in its sole discretion. Any surplus shall be paid to Borrower or other Persons legally entitled thereto; Borrower shall remain liable to Bank for any deficiency. If Bank, in its good faith business judgment, directly or indirectly enters into a deferred payment or other credit transaction with any purchaser at any sale of Collateral, Bank shall have the option, exercisable at any time, of either reducing the Obligations by the principal amount of the purchase price or deferring the reduction of the Obligations until the actual receipt by Bank of cash therefor.

**9.5 Bank's Liability for Collateral.** So long as Bank complies with reasonable banking practices regarding the safekeeping of the Collateral in the possession or under the control of Bank, Bank shall not be liable or responsible for: (a) the safekeeping of the Collateral; (b) any loss or damage to the Collateral; (c) any diminution in the value of the Collateral; or (d) any act or default of any carrier, warehouseman, bailee, or other Person. Borrower bears all risk of loss, damage or destruction of the Collateral.

**9.6 No Waiver; Remedies Cumulative.** Bank's failure, at any time or times, to require strict performance by Borrower of any provision of this Agreement or any other Loan Document shall not waive, affect, or diminish any right of Bank thereafter to demand strict performance and compliance herewith or therewith. No waiver hereunder shall be effective unless signed by Bank and then is only effective for the specific instance and purpose for which it is given. Bank's rights and remedies under this Agreement and the other Loan Documents are cumulative. Bank has all rights and remedies provided under the Code, by law, or in equity. Bank's exercise of one right or remedy is not an election, and Bank's waiver of any Event of Default is not a continuing waiver. Bank's delay in exercising any remedy is not a waiver, election, or acquiescence.

**9.7 Demand Waiver.** Borrower waives demand, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guarantees held by Bank on which Borrower is liable.

## **10 NOTICES**

All notices, consents, requests, approvals, demands, or other communication (collectively, "**Communication**"), other than Advance requests made pursuant to Section 3.4, by any party to this Agreement or any other Loan Document must be in writing and be delivered or sent by facsimile at the addresses or facsimile numbers listed below. Bank or Borrower may change its notice address by giving the other party written notice thereof. Each such Communication shall be deemed to have been validly served, given, or delivered: (a) upon the earlier of actual receipt and three (3) Business Days after deposit in the U.S. mail, registered or certified mail, return receipt requested, with proper postage prepaid; (b) upon transmission, when sent by facsimile transmission (with such facsimile promptly confirmed by delivery of a copy by personal delivery or United States mail as otherwise provided in this Section 10); (c) one (1) Business Day after deposit with a reputable overnight courier with all charges prepaid; or (d) when delivered, if hand-delivered by messenger, all of which shall be addressed to the party to be notified and sent to the address or facsimile number indicated below. Advance requests made pursuant to Section 3.4 must be in writing and may be in the form of electronic mail, delivered to Bank by Borrower at the e-mail address of Bank provided below and shall be deemed to have been validly served, given, or delivered when sent (with such electronic mail promptly confirmed by delivery of a copy by personal delivery or United States mail as otherwise provided in this Section 10). Bank or Borrower may change its address, facsimile number, or

electronic mail address by giving the other party written notice thereof in accordance with the terms of this Section 10.

If to Borrower: Iteris, Inc.  
1515 South Manchester Avenue  
Anaheim, CA 92802  
Attn: James S. Miele  
Fax: 714-780-7246  
Email: [jsm@iteris.com](mailto:jsm@iteris.com)

If to Bank: Silicon Valley Bank  
38 Technology West, Suite 150  
Irvine, CA 92618  
Attn: Derek Brunelle  
Fax: 949-789-1930  
Email: [dbrunelle@svb.com](mailto:dbrunelle@svb.com)

# **11 CHOICE OF LAW, VENUE, JURY TRIAL WAIVER AND JUDICIAL REFERENCE.**

California law governs the Loan Documents without regard to principles of conflicts of law. Borrower and Bank each submit to the exclusive jurisdiction of the State and Federal courts in Santa Clara County, California; provided, however, that nothing in this Agreement shall be deemed to operate to preclude Bank from bringing suit or taking other legal action in any other jurisdiction to realize on the Collateral or any other security for the Obligations, or to enforce a judgment or other court order in favor of Bank. Borrower expressly submits and consents in advance to such jurisdiction in any action or suit commenced in any such court, and Borrower hereby waives any objection that it may have based upon lack of personal jurisdiction, improper venue, or forum non conveniens and hereby consents to the granting of such legal or equitable relief as is deemed appropriate by such court. Borrower hereby waives personal service of the summons, complaints, and other process issued in such action or suit and agrees that service of such summons, complaints, and other process may be made by registered or certified mail addressed to Borrower at the address set forth in Section 10 of this Agreement and that service so made shall be deemed completed upon the earlier to occur of Borrower's actual receipt thereof or three (3) days after deposit in the U.S. mails, proper postage prepaid.

**TO THE EXTENT PERMITTED BY APPLICABLE LAW, BORROWER AND BANK EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF OR BASED UPON THIS AGREEMENT, THE LOAN DOCUMENTS OR ANY CONTEMPLATED TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. THIS WAIVER IS A MATERIAL INDUCEMENT FOR BOTH PARTIES TO ENTER INTO THIS AGREEMENT. EACH PARTY HAS REVIEWED THIS WAIVER WITH ITS COUNSEL.**

**WITHOUT INTENDING IN ANY WAY TO LIMIT THE PARTIES' AGREEMENT TO WAIVE THEIR RESPECTIVE RIGHT TO A TRIAL BY JURY, if the above waiver of the right to a trial by jury is not enforceable, the parties hereto agree that any and all disputes or controversies of any nature between them arising at any time shall be decided by a reference to a private judge, mutually selected by the parties (or, if they cannot agree, by the Presiding Judge of the Santa Clara County, California Superior Court) appointed in accordance with California Code of Civil Procedure Section 638 (or pursuant to comparable provisions of federal law if the dispute falls within the exclusive jurisdiction of the federal courts), sitting without a jury, in Santa Clara County, California; and the parties hereby submit to the jurisdiction of such court. The reference proceedings shall be conducted pursuant to and in accordance with the provisions of California Code of Civil Procedure §§ 638 through 645.1, inclusive. The private judge shall have the power, among others, to grant provisional relief, including without limitation, entering temporary restraining orders, issuing preliminary and permanent injunctions and appointing receivers. All such proceedings shall be closed to the public and confidential and all records relating thereto shall be permanently sealed. If during the course of any dispute, a party desires to seek provisional relief, but a judge has not been appointed at that point pursuant to the judicial reference procedures, then such party may apply to the Santa Clara County, California Superior Court for such relief. The proceeding before the private judge shall be conducted in the same manner as it would be before a**

court under the rules of evidence applicable to judicial proceedings. The parties shall be entitled to discovery which shall be conducted in the same manner as it would be before a court under the rules of discovery applicable to judicial proceedings. The private judge shall oversee discovery and may enforce all discovery rules and order applicable to judicial proceedings in the same manner as a trial court judge. The parties agree that the selected or appointed private judge shall have the power to decide all issues in the action or proceeding, whether of fact or of law, and shall report a statement of decision thereon pursuant to the California Code of Civil Procedure § 644(a). Nothing in this paragraph shall limit the right of any party at any time to exercise self-help remedies, foreclose against collateral, or obtain provisional remedies. The private judge shall also determine all issues relating to the applicability, interpretation, and enforceability of this paragraph.

## **12      GENERAL PROVISIONS**

**12.1      Successors and Assigns.** This Agreement binds and is for the benefit of the successors and permitted assigns of each party. Borrower may not assign this Agreement or any rights or obligations under it without Bank's prior written consent (which may be granted or withheld in Bank's discretion). Bank has the right, without the consent of or notice to Borrower, to sell, transfer, negotiate, or grant participation in all or any part of, or any interest in, Bank's obligations, rights, and benefits under this Agreement and the other Loan Documents.

**12.2      Indemnification.** Borrower agrees to indemnify, defend and hold Bank and its directors, officers, employees, agents, attorneys, or any other Person affiliated with or representing Bank harmless against: (a) all obligations, demands, claims, and liabilities (collectively, "Claims") asserted by any other party in connection with the transactions contemplated by the Loan Documents; and (b) all losses or Bank Expenses incurred, or paid by Bank from, following, or arising from transactions between Bank and Borrower (including reasonable attorneys' fees and expenses), except for Claims and/or losses directly caused by Bank's gross negligence or willful misconduct.

**12.3      Limitation of Actions.** Any claim or cause of action by Borrower against Bank, its directors, officers, employees, agents, accountants, attorneys, or any other Person affiliated with or representing Bank based upon, arising from, or relating to this Loan Agreement or any other Loan Document, or any other transaction contemplated hereby or thereby or relating hereto or thereto, or any other matter, cause or thing whatsoever, occurred, done, omitted or suffered to be done by Bank, its directors, officers, employees, agents, accountants or attorneys, shall be barred unless asserted by Borrower by the commencement of an action or proceeding in a court of competent jurisdiction by (a) the filing of a complaint within one year from the earlier of (i) the date any of Borrower's officers or directors had knowledge of the first act, the occurrence or omission upon which such claim or cause of action, or any part thereof, is based, or (ii) the date this Agreement is terminated, and (b) the service of a summons and complaint on an officer of Bank, or on any other person authorized to accept service on behalf of Bank, within thirty (30) days thereafter. Borrower agrees that such one-year period is a reasonable and sufficient time for Borrower to investigate and act upon any such claim or cause of action. The one-year period provided herein shall not be waived, tolled, or extended except by the written consent of Bank in its sole discretion. This provision shall survive any termination of this Loan Agreement or any other Loan Document.

**12.4      Time of Essence.** Time is of the essence for the performance of all Obligations in this Agreement.

**12.5      Severability of Provisions.** Each provision of this Agreement is severable from every other provision in determining the enforceability of any provision.

**12.6      Amendments in Writing; Integration.** All amendments to this Agreement must be in writing signed by both Bank and Borrower. This Agreement and the Loan Documents represent the entire agreement about this subject matter and supersede prior negotiations or agreements. All prior agreements, understandings, representations, warranties, and negotiations between the parties about the subject matter of this Agreement and the Loan Documents merge into this Agreement and the Loan Documents.

**12.7      Counterparts.** This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, are an original, and all taken together, constitute one Agreement.

**12.8      Survival.** All covenants, representations and warranties made in this Agreement continue in full force until this Agreement has terminated pursuant to its terms and all Obligations (other than inchoate indemnity

obligations and any other obligations which, by their terms, are to survive the termination of this Agreement) have been satisfied. The obligation of Borrower in Section 12.2 to indemnify Bank shall survive until the statute of limitations with respect to all claims and causes of action with respect to which indemnity is given to Bank shall have run.

**12.9 Confidentiality.** In handling any confidential information, Bank shall exercise the same degree of care that it exercises for its own proprietary information, but disclosure of information may be made: (a) to Bank's Subsidiaries or Affiliates; (b) to prospective transferees or purchasers of any interest in the Credit Extensions (provided, however, Bank shall use commercially reasonable efforts to obtain such prospective transferee's or purchaser's agreement to the terms of this provision); (c) as required by law, regulation, subpoena, or other order; (d) to Bank's regulators or as otherwise required in connection with Bank's examination or audit; and (e) as Bank considers appropriate in exercising remedies under this Agreement. Confidential information does not include information that either: (i) is in the public domain or in Bank's possession when disclosed to Bank, or becomes part of the public domain after disclosure to Bank; or (ii) is disclosed to Bank by a third party, if Bank does not know that the third party is prohibited from disclosing the information.

**12.10 Attorneys' Fees, Costs and Expenses.** In any action or proceeding between Borrower and Bank arising out of or relating to the Loan Documents, the prevailing party shall be entitled to recover its reasonable attorneys' fees and other costs and expenses incurred, in addition to any other relief to which it may be entitled.

## **13 DEFINITIONS**

**13.1 Definitions.** As used in this Agreement, the following terms have the following meanings:

**"Account"** is any "account" as defined in the Code with such additions to such term as may hereafter be made, and includes, without limitation, all accounts receivable and other sums owing to Borrower.

**"Account Debtor"** is any "account debtor" as defined in the Code with such additions to such term as may hereafter be made.

**"Advance"** or **"Advances"** means an advance (or advances) under the Revolving Line.

**"Affiliate"** of any Person is a Person that owns or controls directly or indirectly the Person, any Person that controls or is controlled by or is under common control with the Person, and each of that Person's senior executive officers, directors, partners and, for any Person that is a limited liability company, that Person's managers and members.

**"Agreement"** is defined in the preamble hereof.

**"Availability Amount"** is at any time (a) the lesser of (i) the Revolving Line or (ii) the Borrowing Base minus (b) the amount of all outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit) minus (c) an amount equal to the Letter of Credit Reserves, minus (d) the FX Reserve, and minus (e) the outstanding principal balance of any Advances (including any amounts used for Cash Management Services) and minus (f) the current principal amount outstanding of the Term Loan.

**"Bank"** is defined in the preamble hereof.

**"Bank Expenses"** are all audit fees and expenses, costs, and expenses (including reasonable attorneys' fees and expenses) for preparing, negotiating, administering, defending and enforcing the Loan Documents (including, without limitation, those incurred in connection with appeals or Insolvency Proceedings) or otherwise incurred with respect to Borrower.

**"Bankruptcy-Related Defaults"** is defined in Section 9.1.

**"Borrower"** is defined in the preamble hereof.

**“Borrower’s Books”** are all Borrower’s books and records including ledgers, federal and state tax returns, records regarding Borrower’s assets or liabilities, the Collateral, business operations or financial condition, and all computer programs or storage or any equipment containing such information.

**“Borrowing Base”** is (a) **85%** of Eligible Accounts, plus (b) the lesser of (i) **30%** of the value of Borrower’s Eligible Inventory (valued at the lower of cost or wholesale fair market value), or (ii) **50%** of the Advances made pursuant to subclause (a) above, or (iii) **\$1,000,000**, as determined by Bank from Borrower’s most recent Transaction Report; provided, however, that Bank may decrease the foregoing percentages in its good faith business judgment based on events, conditions, contingencies, or risks which, as determined by Bank, may adversely affect Collateral.

**“Borrowing Resolutions”** are, with respect to any Person, those resolutions adopted by such Person’s Board of Directors and delivered by such Person to Bank approving the Loan Documents to which such Person is a party and the transactions contemplated thereby, together with a certificate executed by its secretary on behalf of such Person certifying that (a) such Person has the authority to execute, deliver, and perform its obligations under each of the Loan Documents to which it is a party, (b) sets forth the resolutions then in full force and effect authorizing and ratifying the execution, delivery, and performance by such Person of the Loan Documents to which it is a party, (c) the names of the Persons authorized to execute the Loan Documents on behalf of such Person, together with a sample of the true signatures of such Persons, and (d) that Bank may conclusively rely on such certificate unless and until such Person shall have delivered to Bank a further certificate canceling or amending such prior certificate.

**“Business Day”** is any day that is not a Saturday, Sunday or a day on which Bank is closed.

**“Cash Equivalents”** means (a) marketable direct obligations issued or unconditionally guaranteed by the United States or any agency or any State thereof having maturities of not more than one (1) year from the date of acquisition; (b) commercial paper maturing no more than one (1) year after its creation and having the highest rating from either Standard & Poor’s Ratings Group or Moody’s Investors Service, Inc., (c) Bank’s certificates of deposit issued maturing no more than one (1) year after issue; and (d) money market funds at least ninety-five percent (95%) of the assets of which constitute Cash Equivalents of the kinds described in clauses (a) through (c) of this definition.

**“Cash Management Services”** is defined in Section 2.1.4.

**“Cash Management Services Sublimit”** is defined in Section 2.1.4.

**“Code”** is the Uniform Commercial Code, as the same may, from time to time, be enacted and in effect in the State of California; provided, that, to the extent that the Code is used to define any term herein or in any Loan Document and such term is defined differently in different Articles or Divisions of the Code, the definition of such term contained in Article or Division 9 shall govern; provided further, that in the event that, by reason of mandatory provisions of law, any or all of the attachment, perfection, or priority of, or remedies with respect to, Bank’s Lien on any Collateral is governed by the Uniform Commercial Code in effect in a jurisdiction other than the State of California, the term **“Code”** shall mean the Uniform Commercial Code as enacted and in effect in such other jurisdiction solely for purposes on the provisions thereof relating to such attachment, perfection, priority, or remedies and for purposes of definitions relating to such provisions.

**“Collateral”** is any and all properties, rights and assets of Borrower described on Exhibit A.

**“Collateral Account”** is any Deposit Account, Securities Account, or Commodity Account.

**“Commodity Account”** is any “commodity account” as defined in the Code with such additions to such term as may hereafter be made.

**“Communication”** is defined in Section 10.

**“Compliance Certificate”** is that certain certificate in the form attached hereto as Exhibit E.

**“Contingent Obligation”** is, for any Person, any direct or indirect liability, contingent or not, of that Person for (a) any indebtedness, lease, dividend, letter of credit or other obligation of another such as an obligation

directly or indirectly guaranteed, endorsed, co-made, discounted or sold with recourse by that Person, or for which that Person is directly or indirectly liable; (b) any obligations for undrawn letters of credit for the account of that Person; and (c) all obligations from any interest rate, currency or commodity swap agreement, interest rate cap or collar agreement, or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices; but “Contingent Obligation” does not include endorsements in the ordinary course of business. The amount of a Contingent Obligation is the stated or determined amount of the primary obligation for which the Contingent Obligation is made or, if not determinable, the maximum reasonably anticipated liability for it determined by the Person in good faith; but the amount may not exceed the maximum of the obligations under any guarantee or other support arrangement.

“**Control Agreement**” is any control agreement entered into among the depository institution at which Borrower maintains a Deposit Account or the securities intermediary or commodity intermediary at which Borrower maintains a Securities Account or a Commodity account, Borrower, and Bank pursuant to which Bank obtains control (within the meaning of the Code) over such Deposit Account, Securities Account, or Commodity Account.

“**Credit Extension**” is any Advance, Term Loan, Letter of Credit, FX Forward Contract, amount utilized for Cash Management Services, or any other extension of credit by Bank for Borrower’s benefit.

“**Default**” means any event which with notice or passage of time or both, would constitute an Event of Default.

“**Default Rate**” is defined in Section 2.3(b).

“**Deferred Revenue**” is all amounts received or invoiced in advance of performance under contracts and not yet recognized as revenue.

“**Deposit Account**” is any “deposit account” as defined in the Code with such additions to such term as may hereafter be made.

“**Designated Deposit Account**” is Borrower’s deposit account, account number \_\_\_\_\_, maintained with Bank.

“**Dollars**,” “**dollars**” and “**\$**” each mean lawful money of the United States.

“**Effective Date**” is the date Bank executes this Agreement and as indicated on the signature page hereof.

“**Eligible Accounts**” are Accounts which arise in the ordinary course of Borrower’s business that meet all Borrower’s representations and warranties in Section 5.3. Bank reserves the right at any time and from time to time after the Effective Date, to adjust any of the criteria set forth below and to establish new criteria in its good faith business judgment. Unless Bank agrees otherwise in writing, Eligible Accounts shall not include:

- (a) Accounts for which the Account Debtor has not been invoiced;
- (b) Accounts that the Account Debtor has not paid within ninety (90) days of invoice date;
- (c) Accounts owing from an Account Debtor, fifty percent (50%) or more of whose Accounts have not been paid within ninety (90) days of invoice date;
- (d) Credit balances over ninety (90) days from invoice date;
- (e) Accounts owing from an Account Debtor, including Affiliates, whose total obligations to Borrower exceed twenty-five (25%) of all Accounts, for the amounts that exceed that percentage, unless Bank approves in writing;
- (f) Accounts owing from an Account Debtor which does not have its principal place of business in the United States (unless backed by a letter of credit satisfactory to Bank, or FCIA insured satisfactory to Bank); provided, however, otherwise Eligible Accounts owing from the following foreign Account Debtors will be deemed Eligible Accounts up to an aggregate of \$1,000,000 for all Accounts from such Account Debtors combined: (i)



Valeo Schalter, (ii) Scania, (iii) Neoplan, (iv) Man Nutzfahrzeuge, (v) Iveco Magirus, (vi) DAF Trucks, (vii) Mitsubishi FUSO Truck and Bus Corporation and (viii) Iteris Europe, GmbH.

(g) Accounts owing from an Account Debtor which is a federal government entity or any department, agency, or instrumentality thereof (the “Federal Government”); provided, however, with respect to Accounts owing from the Federal Government, those Accounts will not be deemed Eligible Accounts only to the extent such Accounts exceed five percent (5.0%) of the total Eligible Accounts outstanding; provided, further, that with respect to the portion of such Accounts in excess of five percent (5.0%) of the total Eligible Accounts Outstanding, that portion may still be considered Eligible Accounts if Borrower has assigned its payment rights to Bank and the assignment has been acknowledged under the Federal Assignment of Claims Act of 1940, as amended;

(h) Accounts owing from an Account Debtor to the extent that Borrower is indebted or obligated in any manner to the Account Debtor (as creditor, lessor, supplier or otherwise - sometimes called “contra” accounts, accounts payable, customer deposits or credit accounts), with the exception of customary credits, adjustments and/or discounts given to an Account Debtor by Borrower in the ordinary course of its business; provided, however, that if the amount of any such indebtedness or obligation of the Borrower is known, then only to the extent of the asserted amount of such indebtedness or obligation;

(i) Accounts for demonstration or promotional equipment, or in which goods are consigned, or sold on a “sale guaranteed”, “sale or return”, “sale on approval”, “bill and hold”, or other terms if Account Debtor’s payment may be conditional;

(j) Accounts for which the Account Debtor is Borrower’s Affiliate, officer, employee, or agent;

(k) Accounts in which the Account Debtor disputes liability or makes any claim (but only up to the disputed or claimed amount), or if the Account Debtor is subject to an Insolvency Proceeding, or becomes insolvent, or goes out of business;

(l) Accounts owing from an Account Debtor with respect to which Borrower has received deferred revenue (but only to the extent of such deferred revenue);

(m) Accounts for which Bank in its good faith business judgment determines collection to be doubtful; and

(n) other Accounts Bank deems ineligible in the exercise of its good faith business judgment.

“**Eligible Inventory**” means, at any time, the aggregate of Borrower’s Inventory that (a) consists of raw materials and finished goods, in good, new, and salable condition, which is not perishable, returned, consigned, obsolete, not sellable, damaged, or defective, and is not comprised of demonstrative or custom inventory, works in progress, packaging or shipping materials, or supplies; (b) meets all applicable governmental standards; (c) has been manufactured in compliance with the Fair Labor Standards Act; (d) is not subject to any Liens (other than Permitted Liens), except the first priority Liens granted or in favor of Bank under this Agreement or any of the other Loan Documents; (e) is located at Borrower’s principal place of business; and (f) is otherwise acceptable to Bank in its good faith business judgment. Notwithstanding subclause (a) above, sub-assembly processors for detection devices are considered Eligible Inventory to the extent they satisfy subclauses (b) through (f) above.

“**Equipment**” is all “equipment” as defined in the Code with such additions to such term as may hereafter be made, and includes without limitation all machinery, fixtures, goods, vehicles (including motor vehicles and trailers), and any interest in any of the foregoing.

“**ERISA**” is the Employment Retirement Income Security Act of 1974, and its regulations.

“**Event of Default**” is defined in Section 8.

“**Foreign Currency**” means lawful money of a country other than the United States.

“**Funding Date**” is any date on which a Credit Extension is made to or on account of Borrower which shall be a Business Day.

**“FX Business Day”** is any day when (a) Bank’s Foreign Exchange Department is conducting its normal business and (b) the Foreign Currency being purchased or sold by Borrower is available to Bank from the entity from which Bank shall buy or sell such Foreign Currency.

**“FX Forward Contract”** is defined in Section 2.1.3.

**“FX Reserve”** is defined in Section 2.1.3.

**“GAAP”** is generally accepted accounting principles set forth in the opinions and pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board or in such other statements by such other Person as may be approved by a significant segment of the accounting profession, which are applicable to the circumstances as of the date of determination.

**“General Intangibles”** is all “general intangibles” as defined in the Code in effect on the date hereof with such additions to such term as may hereafter be made, and includes without limitation, all Intellectual Property, payment intangibles, royalties, contract rights, goodwill, franchise agreements, purchase orders, customer lists, route lists, telephone numbers, domain names, claims, income and other tax refunds, security and other deposits, options to purchase or sell real or personal property, rights in all litigation presently or hereafter pending (whether in contract, tort or otherwise), insurance policies (including without limitation key man, property damage, and business interruption insurance), payments of insurance and rights to payment of any kind.

**“Guarantor”** is any present or future guarantor of the Obligations.

**“Indebtedness”** is (a) indebtedness for borrowed money or the deferred price of property or services, such as reimbursement and other obligations for surety bonds and letters of credit, (b) obligations evidenced by notes, bonds, debentures or similar instruments, (c) capital lease obligations, and (d) Contingent Obligations.

**“Insolvency Proceeding”** is any proceeding by or against any Person under the United States Bankruptcy Code, or any other bankruptcy or insolvency law, including assignments for the benefit of creditors, compositions, extensions generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

**“Intellectual Property”** means all present and future (a) copyrights, copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work thereof, whether published or unpublished, (b) trade secret rights, including all rights to unpatented inventions and know-how, and confidential information; (c) mask work or similar rights available for the protection of semiconductor chips; (d) patents, patent applications and like protections including without limitation improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same; (e) trademarks, servicemarks, trade styles, and trade names, whether or not any of the foregoing are registered, and all applications to register and registrations of the same and like protections, and the entire goodwill of the business of Borrower connected with and symbolized by any such trademarks; (f) computer software and computer software products; (g) designs and design rights; (h) technology; (i) all claims for damages by way of past, present and future infringement of any of the rights included above; (j) all licenses or other rights to use any property or rights of a type described above.

**“Inventory”** is all “inventory” as defined in the Code in effect on the date hereof with such additions to such term as may hereafter be made, and includes without limitation all merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products, including without limitation such inventory as is temporarily out of Borrower’s custody or possession or in transit and including any returned goods and any documents of title representing any of the above.

**“Investment”** is any beneficial ownership interest in any Person (including stock, partnership interest or other securities), and any loan, advance or capital contribution to any Person.

**“IP Agreement”** is that certain Intellectual Property Security Agreement executed and delivered by Borrower to Bank dated as of approximately the Effective Date hereof.

“**Letter of Credit**” means a standby letter of credit issued by Bank or another institution based upon an application, guarantee, indemnity or similar agreement on the part of Bank as set forth in Section 2.1.2.

“**Letter of Credit Application**” is defined in Section 2.1.2(a).

“**Letter of Credit Reserve**” has the meaning set forth in Section 2.1.2(d).

“**Lien**” is a mortgage, lien, deed of trust, charge, pledge, security interest or other encumbrance.

“**Loan Documents**” are, collectively, this Agreement, the Perfection Certificate, the IP Agreement, the Subordination Agreement, any note, or notes or guaranties executed by Borrower or any Guarantor, and any other present or future agreement between Borrower or any Guarantor and/or for the benefit of Bank in connection with this Agreement, all as amended, restated, or otherwise modified.

“**Material Adverse Change**” is (a) a material impairment in the perfection or priority of Bank’s Lien in the Collateral or in the value of such Collateral; (b) a material adverse change in the business, operations, or condition (financial or otherwise) of Borrower; or (c) a material impairment of the prospect of repayment of any portion of the Obligations or (d) Bank determines, based upon information available to it and in its good faith judgment, that there is a reasonable likelihood that Borrower shall fail to comply with one or more of the financial covenants in Section 6 during the next succeeding financial reporting period.

“**Maximum Dollar Amount**” is \$8,000,000.

“**Obligations**” are Borrower’s obligation to pay when due any debts, principal, interest, Bank Expenses and other amounts Borrower owes Bank now or later, whether under this Agreement, the Loan Documents, or otherwise, including, without limitation, all obligations relating to letters of credit, cash management services, and foreign exchange contracts, if any, and including interest accruing after Insolvency Proceedings begin and debts, liabilities, or obligations of Borrower assigned to Bank, and the performance of Borrower’s duties under the Loan Documents.

“**Operating Documents**” are, for any Person, such Person’s formation documents, as certified with the Secretary of State of such Person’s state of formation on a date that is no earlier than 30 days prior to the Effective Date, and, (a) if such Person is a corporation, its bylaws in current form, (b) if such Person is a limited liability company, its limited liability company agreement (or similar agreement), and (c) if such Person is a partnership, its partnership agreement (or similar agreement), each of the foregoing with all current amendments or modifications thereto.

“**Payment/Advance Form**” is that certain form attached hereto as Exhibit B.

“**Perfection Certificate**” is defined in Section 5.1.

“**Permitted Indebtedness**” is:

- (a) Borrower’s Indebtedness to Bank under this Agreement and the other Loan Documents;
- (b) Indebtedness existing on the Effective Date and shown on the Perfection Certificate;
- (c) Subordinated Debt;
- (d) unsecured Indebtedness to trade creditors incurred in the ordinary course of business;
- (e) Indebtedness incurred as a result of endorsing negotiable instruments received in the ordinary course of business;
- (f) Indebtedness secured by Permitted Liens;

(g) extensions, refinancings, modifications, amendments and restatements of any items of Permitted Indebtedness (a) through (g) above, provided that the principal amount thereof is not increased or the terms thereof are not modified to impose more burdensome terms upon Borrower or its Subsidiary, as the case may be.

**“Permitted Investments” are:**

- (a) Investments shown on the Perfection Certificate and existing on the Effective Date;
- (b) Cash Equivalents;
- (c) Investments consisting of the endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of Borrower;
- (d) Investments consisting of deposit accounts in which Bank has a perfected security interest;
- (e) Investments accepted in connection with Transfers permitted by Section 7.1;
- (f) Investments of Subsidiaries in or to other Subsidiaries or Borrower and Investments by Borrower in Subsidiaries not to exceed \$50,000 in the aggregate in any fiscal year;
- (g) Investments consisting of (i) travel advances and employee relocation loans and other employee loans and advances in the ordinary course of business, and (ii) loans to employees, officers or directors relating to the purchase of equity securities of Borrower or its Subsidiaries pursuant to employee stock purchase plans or agreements approved by Borrower’s Board of Directors;
- (h) Investments (including debt obligations) received in connection with the bankruptcy or reorganization of customers or suppliers and in settlement of delinquent obligations of, and other disputes with, customers or suppliers arising in the ordinary course of business; and
- (i) Investments consisting of notes receivable of, or prepaid royalties and other credit extensions, to customers and suppliers who are not Affiliates, in the ordinary course of business; provided that this paragraph shall not apply to Investments of Borrower in any Subsidiary.

**“Permitted Liens” are:**

- (a) Liens existing on the Effective Date and shown on the Perfection Certificate or arising under this Agreement and the other Loan Documents;
- (b) Liens for taxes, fees, assessments or other government charges or levies, either not delinquent or being contested in good faith and for which Borrower maintains adequate reserves on its Books, if they have no priority over any of Bank’s Liens;
- (c) purchase money Liens (i) on Equipment acquired or held by Borrower incurred for financing the acquisition of the Equipment, or (ii) existing on Equipment when acquired, if the Lien is confined to the property and improvements and the proceeds of the Equipment;
- (d) statutory Liens securing claims or demands of materialmen, mechanics, carriers, warehousemen, landlords and other Persons imposed without action of such parties, provided, they have no priority over any of Bank’s Lien and the aggregate amount of such Liens does not at any time exceed \$50,000;
- (e) Liens to secure payment of workers’ compensation, employment insurance, old-age pensions, social security and other like obligations incurred in the ordinary course of business, provided, they have no priority over any of Bank’s Liens and the aggregate amount of the Indebtedness secured by such Liens does not at any time exceed \$50,000;
- (f) Liens incurred in the extension, renewal or refinancing of the indebtedness secured by Liens described in (a) through (c), but any extension, renewal or replacement Lien must be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness may not increase;

(g) leases or subleases of real property granted in the ordinary course of business, and leases, subleases, non-exclusive licenses or sublicenses of property (other than real property or intellectual property) granted in the ordinary course of Borrower's business, if the leases, subleases, licenses and sublicenses do not prohibit granting Bank a security interest;

(h) non-exclusive license of intellectual property granted to third parties in the ordinary course of business;

(i) Liens arising from judgments, decrees or attachments in circumstances not constituting an Event of Default under Section 8.4 or 8.7;

**"Person"** is any individual, sole proprietorship, partnership, limited liability company, joint venture, company, trust, unincorporated organization, association, corporation, institution, public benefit corporation, firm, joint stock company, estate, entity or government agency.

**"Prime Rate"** is Bank's most recently announced "prime rate," even if it is not Bank's lowest rate.

**"Registered Organization"** is any "registered organization" as defined in the Code with such additions to such term as may hereafter be made

**"Responsible Officer"** is any of the Chief Executive Officer, President, Chief Financial Officer and Controller of Borrower.

**"Revolving Line"** is an Advance or Advances in an aggregate amount of up to the **Maximum Dollar Amount** outstanding at any time.

**"Revolving Line Maturity Date"** is a date two years from the Effective Date.

**"Securities Account"** is any "securities account" as defined in the Code with such additions to such term as may hereafter be made.

**"Settlement Date"** is defined in Section 2.1.3.

**"Subordinated Debt"** is indebtedness incurred by Borrower subordinated to all of Borrower's now or hereafter indebtedness to Bank (pursuant to a subordination, intercreditor, or other similar agreement in form and substance satisfactory to Bank entered into between Bank and the other creditor), on terms acceptable to Bank.

**"Subsidiary"** means, with respect to any Person, any Person of which more than 50% of the voting stock or other equity interests is owned or controlled, directly or indirectly, by such Person or one or more Affiliates of such Person.

**"Tangible Net Worth"** is, on any date, the consolidated total assets of Borrower and its Subsidiaries minus (a) any amounts attributable to (i) goodwill, (ii) intangible items including unamortized debt discount and expense, patents, trade and service marks and names, copyrights and research and development expenses except prepaid expenses, (iii) notes, accounts receivable and other obligations owing to Borrower from its officers or other Affiliates, and (iv) reserves not already deducted from assets, minus (b) Total Liabilities, plus (c) Subordinated Debt.

**"Term Loan"** is a loan made by Bank pursuant to the terms of Section 2.1.6 hereof.

**"Term Loan Amount"** is an aggregate amount up to \$2,200,000 but not to exceed the amount necessary to pay Borrower's loan obligations to Wells Fargo Bank.

**"Term Loan Maturity Date"** is May 27, 2008.

**"Term Loan Payment"** is defined in Section 2.1.6(b).

“**Total Liabilities**” is on any day, obligations that should, under GAAP, be classified as liabilities on Borrower’s consolidated balance sheet, including all Indebtedness, and current portion of Subordinated Debt permitted by Bank to be paid by Borrower, but excluding all other Subordinated Debt.

“**Transaction Report**” is a report in such form as Bank shall specify.

“**Transfer**” is defined in Section 7.1.

“**Unused Revolving Line Facility Fee**” is defined in Section 2.4(d).

[Signature page follows.]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the Effective Date.

BORROWER:

ITERIS, INC.

By                     /S/ JAMES S. MIELE                      
Name:                     James S. Miele                      
Title:                     CFO                    

BANK:

SILICON VALLEY BANK

By                     /S/ DEREK BRUNELLE                      
Name:                     Derek Brunelle                      
Title:                     Vice President                      
Effective Date:                     October 16, 2006                    

Exhibits

A        “Collateral”  
B        Loan Payment/Advance Request Form  
C        [intentionally omitted]  
D        [intentionally omitted]  
E        Compliance Certificate  
F        Transaction Report

[Signature page to Loan and Security Agreement]

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**EXHIBIT A**

The Collateral consists of all of Borrower's right, title and interest in and to the following personal property:

All goods, Accounts (including health-care receivables), Equipment, Inventory, contract rights or rights to payment of money, leases, license agreements, franchise agreements, General Intangibles, commercial tort claims, documents, instruments (including any promissory notes), chattel paper (whether tangible or electronic), cash, deposit accounts, fixtures, letters of credit rights (whether or not the letter of credit is evidenced by a writing), securities, and all other investment property, supporting obligations, and financial assets, whether now owned or hereafter acquired, wherever located; and all Borrower's Books relating to the foregoing, and any and all claims, rights and interests in any of the above and all substitutions for, additions, attachments, accessories, accessions and improvements to and replacements, products, proceeds and insurance proceeds of any or all of the foregoing.



**EXHIBIT B**

**Loan Payment/Advance Request Form**

**DEADLINE FOR SAME DAY PROCESSING IS NOON P.S.T.\***

Fax To:

Date: \_\_\_\_\_

**LOAN PAYMENT:**

Iteris,  
Inc.

From Account #

To  
Account  
#

(Deposit Account #)

(Loan  
Account #)

Principal \$

and/or  
Interest \$

**Authorized Signature:**

Print Name/Title:

Phone  
Number: \_\_\_\_\_

**LOAN ADVANCE:**

Complete *Outgoing Wire Request* section below if all or a portion of the funds from this loan advance are for an outgoing wire.

From Account #

To  
Account  
#

(Loan Account #)

(Deposit  
Account #)

Amount of Advance \$

All Borrower's representations and warranties in the Loan and Security Agreement are true, correct and complete in all material respects on the date of the request for an advance; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date:

**Authorized Signature:**

Print Name/Title:

Phone  
Number: \_\_\_\_\_

**OUTGOING WIRE REQUEST:**

**Complete only if all or a portion of funds from the loan advance above is to be wired.**

Deadline for same day processing is noon, P.S.T.

Beneficiary Name:

Amount  
of Wire: \$

Beneficiary Bank:

Account  
Number:

City and State:

Beneficiary Bank Transit (ABA) #:

Beneficiary Bank Code (Swift,  
Sort, Chip, etc.):  
**(For International Wire  
Only)**

Intermediary Bank:

Transit  
(ABA) #:

For Further Credit to:

Special Instruction:

*By signing below, I (we) acknowledge and agree that my (our) funds transfer request shall be processed in accordance with and subject to the terms and conditions set forth in the agreements(s) covering funds transfer service(s), which agreements(s) were previously received and executed by me (us).*

Authorized Signature: \_\_\_\_\_  
Print Name/Title: \_\_\_\_\_  
Telephone #: \_\_\_\_\_

2<sup>nd</sup> Signature (if required): \_\_\_\_\_  
Print Name/Title: \_\_\_\_\_  
Telephone #: \_\_\_\_\_

**EXHIBIT E**

**COMPLIANCE CERTIFICATE**

TO: SILICON VALLEY BANK  
FROM: ITERIS, INC.

Date:

The undersigned authorized officer of Iteris, Inc. ("Borrower") certifies that under the terms and conditions of the Loan and Security Agreement between Borrower and Bank (the "Agreement"), (1) Borrower is in complete compliance for the period ending \_\_\_\_\_ with all required covenants except as noted below, (2) there are no Events of Default, (3) all representations and warranties in the Agreement are true and correct in all material respects on this date except as noted below; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, (4) Borrower, and each of its Subsidiaries, has timely filed all required tax returns and reports, and Borrower has timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower except as otherwise permitted pursuant to the terms of Section 5.9 of the Agreement, and (5) no Liens have been levied or claims made against Borrower or any of its Subsidiaries relating to unpaid employee payroll or benefits of which Borrower has not previously provided written notification to Bank. Attached are the required documents supporting the certification. The undersigned certifies that these are prepared in accordance with generally GAAP consistently applied from one period to the next except as explained in an accompanying letter or footnotes. The undersigned acknowledges that no borrowings may be requested at any time or date of determination that Borrower is not in compliance with any of the terms of the Agreement, and that compliance is determined not just at the date this certificate is delivered. Capitalized terms used but not otherwise defined herein shall have the meanings given them in the Agreement.

**Please indicate compliance status by circling Yes/No under "Complies" column.**

<u>Reporting Covenant</u>	<u>Required</u>	<u>Complies</u>
Monthly financial statements with Compliance Certificate	Monthly within 30 days	Yes No
Transaction Reports	Weekly and with each Advance request	Yes No
10-Q, 10-K and 8-K	Within 5 days after filing with SEC	Yes No
A/R & A/P Agings, Reconciliations and Inventory Reports	Monthly within 15 days	Yes No
Annual Projections, Budgets, etc. for upcoming fiscal year	Within 30 days prior to end of current fiscal year	Yes No

The following Intellectual Property was registered after the Effective Date (if no registrations, state "None")

<u>Financial Covenant</u>	<u>Required</u>	<u>Actual</u>	<u>Complies</u>
Maintain on a Monthly Basis: Minimum Tangible Net Worth	\$4,000,000 plus (i) 25% of all consideration for equity securities and subordinated debt plus (ii) 25% of quarterly net income	\$	Yes No

The following financial covenant analysis and information set forth in Schedule 1 attached hereto are true and accurate as of the date of this Certificate.

The following are the exceptions with respect to the certification above: (If no exceptions exist, state “No exceptions to note.”)

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Iteris, Inc.

**BANK USE ONLY**

Received by: \_\_\_\_\_  
AUTHORIZED SIGNER

Date:

Verified: \_\_\_\_\_  
AUTHORIZED SIGNER

Date:

Compliance Status:      Yes   No

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

**Schedule 1 to Compliance Certificate**

**Financial Covenants of Borrower**

Dated: \_\_\_\_\_

**Tangible Net Worth** (Section 6.9(a))

Required: **\$4,000,000** plus (i) 25% of all consideration received for equity securities and subordinated debt of the Borrower, plus (ii) 25% of the Borrower's net income in each fiscal quarter

Actual:

- |    |   |          |
|----|---|----------|
| A. | Aggregate value of total assets of Borrower and its Subsidiaries  | \$ _____ |
| B. | Aggregate value of goodwill of Borrower and its Subsidiaries  | \$ _____ |
| C. | Aggregate value of intangible assets of Borrower and its Subsidiaries   | \$ _____ |
| D. | Aggregate value of investments of Borrower and its Subsidiaries consisting of minority investments in companies which investments are not publicly-traded   | \$ _____ |
| E. | Aggregate value of any reserves not already deducted from assets  | \$ _____ |
| F. | Aggregate value of liabilities of Borrower and its Subsidiaries (including all Indebtedness) and current portion of Subordinated Debt permitted by Bank to be paid by Borrower (but no other Subordinated Debt) | \$ _____ |
| G. | Aggregate value of Indebtedness of Borrower subordinated to Borrower's Indebtedness to Bank   | \$ _____ |
| H. | Tangible Net Worth (line A minus line B minus line C minus line D minus line E minus line F plus line G)  | \$ _____ |

Is line H equal to or greater than \$ \_\_\_\_\_?

\_\_\_\_\_ No, not in compliance

\_\_\_\_\_ Yes, in compliance

**Exhibit F**

Transaction Report

## INTELLECTUAL PROPERTY SECURITY AGREEMENT

This Intellectual Property Security Agreement is entered into as of October 9, 2006 by and between SILICON VALLEY BANK ("Secured Party") and ITERIS, INC. ("Grantor").

RECITALS

A. Secured Party and Grantor are entering into that certain Loan and Security Agreement of even date herewith (as the same may be amended, modified or supplemented from time to time, the "Loan Agreement"; capitalized terms used herein which are not defined, have the meanings set forth in the Loan Agreement).

B. Pursuant to the terms of the Loan Agreement, Grantor has granted to Secured Party a security interest in all of Grantor's right, title and interest, whether presently existing or hereafter acquired, in, to all Intellectual Property and all other Collateral.

NOW, THEREFORE, as collateral security for the payment and performance when due of all of the Obligations, Grantor hereby grants, represents, warrants, covenants and agrees as follows:

AGREEMENT

1. Grant of Security Interest. To secure all of the Obligations, Grantor grants and pledges to Secured Party a security interest in all of Grantor's right, title and interest in, to and under its Intellectual Property (as defined in the Loan Agreement), including without limitation the following:

(a) All of present and future United States registered copyrights and copyright registrations, including, without limitation, the registered copyrights, maskworks, software, computer programs and other works of authorship subject to United States copyright protection listed in Exhibit A-1 to this Agreement (and including all of the exclusive rights afforded a copyright registrant in the United States under 17 U.S.C. § 106 and any exclusive rights which may in the future arise by act of Congress or otherwise) and all present and future applications for copyright registrations (including applications for copyright registrations of derivative works and compilations) (collectively, the "Registered Copyrights"), and any and all royalties, payments, and other amounts payable to Grantor in connection with the Registered Copyrights, together with all renewals and extensions of the Registered Copyrights, the right to recover for all past, present, and future infringements of the Registered Copyrights, and all computer programs, computer databases, computer program flow diagrams, source codes, object codes and all tangible property embodying or incorporating the Registered Copyrights, and all other rights of every kind whatsoever accruing thereunder or pertaining thereto.

(b) All present and future copyrights, maskworks, software, computer programs and other works of authorship subject to (or capable of becoming subject to) United States copyright protection which are not registered in the United States Copyright Office (the "Unregistered Copyrights"), whether now owned or hereafter acquired, including without limitation the Unregistered Copyrights listed in Exhibit A-2 to this Agreement, and any and all royalties, payments, and other amounts payable to Grantor in connection with the Unregistered Copyrights, together with all renewals and extensions of the Unregistered Copyrights, the right to recover for all past, present, and future infringements of the Unregistered Copyrights, and all

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computer programs, computer databases, computer program flow diagrams, source codes, object codes and all tangible property embodying or incorporating the Unregistered Copyrights, and all other rights of every kind whatsoever accruing thereunder or pertaining thereto. The Registered Copyrights and the Unregistered Copyrights collectively are referred to herein as the "Copyrights."

- (c) All right, title and interest in and to any and all present and future license agreements with respect to the Copyrights.
- (d) All present and future accounts, accounts receivable, royalties, and other rights to payment arising from, in connection with or relating to the Copyrights.
- (e) All patents, patent applications and like protections including, without limitation, improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same, including without limitation the patents and patent applications set forth on Exhibit B attached hereto (collectively, the "Patents");
- (f) All trademark and servicemark rights, whether registered or not, applications to register and registrations of the same and like protections, and the entire goodwill of the business of Grantor connected with and symbolized by such trademarks, including without limitation those set forth on Exhibit C attached hereto (collectively, the "Trademarks");
- (g) Any and all claims for damages by way of past, present and future infringements of any of the rights included above, with the right, but not the obligation, to sue for and collect such damages for said use or infringement of the rights identified above;
- (h) All licenses or other rights to use any of the Copyrights, Patents or Trademarks, and all license fees and royalties arising from such use to the extent permitted by such license or rights;
- (i) All amendments, extensions, renewals and extensions of any of the Copyrights, Trademarks or Patents; and
- (j) All proceeds and products of the foregoing, including without limitation all payments under insurance or any indemnity or warranty payable in respect of any of the foregoing, and all license royalties and proceeds of infringement suits, and all rights corresponding to the foregoing throughout the world and all re-issues, divisions continuations, renewals, extensions and continuations-in-part of the foregoing.

2. Loan Agreement. This security interest is granted in conjunction with the security interest granted to Secured Party under the Loan Agreement. The rights and remedies of Secured Party with respect to the security interest granted hereby are in addition to those set forth in the Loan Agreement and the other Loan Documents, and those which are now or hereafter available to Secured Party as a matter of law or equity. Each right, power and remedy of Secured Party provided for herein or in the Loan Agreement or any of the other Loan Documents, or now or hereafter existing at law or in equity shall be cumulative and concurrent and shall be in addition to every right, power or remedy provided for herein and the exercise by Secured Party of any one

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or more of the rights, powers or remedies provided for in this Agreement, the Loan Agreement or any of the other Loan Documents, or now or hereafter existing at law or in equity, shall not preclude the simultaneous or later exercise by any person, including Secured Party, of any or all other rights, powers or remedies.

3. Covenants and Warranties. Grantor represents, warrants, covenants and agrees as follows:

(a) Grantor has no present maskworks, software, computer programs and other works of authorship registered with the United States Copyright Office except as disclosed on Exhibit A-1 hereto.

(b) Grantor shall undertake all reasonable measures to cause its employees, agents and independent contractors to assign to Grantor all rights of authorship to any copyrighted material in which Grantor has or may subsequently acquire any right or interest.

(c) Grantor shall promptly advise Secured Party of any Trademark, Patent or Copyright not specified in this Agreement, which is hereafter acquired by Grantor.

(d) Grantor shall not register any maskworks, software, computer programs or other works of authorship subject to United States copyright protection with the United States Copyright Office without first complying with the following: (i) providing Secured Party with at least 15 days prior written notice thereof, (ii) providing Secured Party with a copy of the application for any such registration and (iii) executing and filing such other instruments, and taking such further actions as Secured Party may reasonably request from time to time to perfect or continue the perfection of Secured Party's interest in the Collateral, including without limitation the filing with the United States Copyright Office, simultaneously with the filing by Grantor of the application for any such registration, of a copy of this Agreement or a Supplement hereto in form acceptable to Secured Party identifying the maskworks, software, computer programs or other works of authorship being registered and confirming the grant of a security interest therein in favor of Secured Party.

4. General. If any action relating to this Agreement is brought by either party hereto against the other party, the prevailing party shall be entitled to recover reasonable attorneys fees, costs and disbursements. This Agreement may be amended only by a written instrument signed by both parties hereto. To the extent that any provision of this Agreement conflicts with any provision of the Loan Agreement, the provision giving Secured Party greater rights or remedies shall govern, it being understood that the purpose of this Agreement is to add to, and not detract from, the rights granted to Secured Party under the Loan Agreement. This Agreement, the Loan Agreement, and the other Loan Documents comprise the entire agreement of the parties with respect to the matters addressed in this Agreement. This Agreement shall be governed by the laws of the State of California, without regard for choice of law provisions. Grantor and Secured Party consent to the nonexclusive jurisdiction of any state or federal court located in Santa Clara County, California.

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5. **WAIVER OF RIGHT TO JURY TRIAL.** SECURED PARTY AND GRANTOR EACH HEREBY WAIVE THE RIGHT TO TRIAL BY JURY IN ANY ACTION OR PROCEEDING BASED UPON, ARISING OUT OF, OR IN ANY WAY RELATING TO: (I) THIS AGREEMENT; OR (II) ANY OTHER PRESENT OR FUTURE INSTRUMENT OR AGREEMENT BETWEEN SECURED PARTY AND GRANTOR; OR (III) ANY CONDUCT, ACTS OR OMISSIONS OF SECURED PARTY OR GRANTOR OR ANY OF THEIR DIRECTORS, OFFICERS, EMPLOYEES, AGENTS, ATTORNEYS OR ANY OTHER PERSONS AFFILIATED WITH SECURED PARTY OR GRANTOR; IN EACH OF THE FOREGOING CASES, WHETHER SOUNDING IN CONTRACT OR TORT OR OTHERWISE.

IN WITNESS WHEREOF, the parties have cause this Intellectual Property Security Agreement to be duly executed by its officers thereunto duly authorized as of the first date written above.

Address of Grantor:

1515 South Manchester Avenue  
Anaheim, California 92892

Grantor:

ITERIS, INC.

By: /S/ JAMES S. MIELE

Title: CFO

Name: James S. Miele

Address of Secured Party:

3003 Tasman Drive  
Santa Clara, California 95054

Secured Party:

SILICON VALLEY BANK

By: /S/ DEREK BRUNELLE

Title: Derek Brunelle, Vice President

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**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 subsidiaries, 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: November 14, 2006

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

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

I, James S. Miele, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Iteris, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) 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: November 14, 2006

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

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

In connection with the Quarterly Report of Iteris, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2006 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

November 14, 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.

**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 September 30, 2006 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

November 14, 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.