

ITERIS, INC.  
Form 10-Q  
February 14, 2011  
[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**Form 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2010

OR

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

For the transition period from            to

Commission file number: 001-08762

## ITERIS, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**95-2588496**

(I.R.S. Employer  
Identification No.)

**1700 Carnegie Avenue, Suite 100  
Santa Ana, California**

(Address of principal executive office)

**92705**

(Zip Code)

**(949) 270-9400**

(Registrant's telephone number, including area code)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Edgar Filing: ITERIS, INC. - Form 10-Q

As of February 4, 2011, there were 34,337,756 shares of common stock outstanding.

---

Table of Contents

**ITERIS, INC.**

**Quarterly Report on Form 10-Q  
For the Three and Nine Months Ended December 31, 2010**

**Table of Contents**

|                        |  |    |
|------------------------|--|----|
| <b><u>PART I.</u></b>  | <b><u>FINANCIAL INFORMATION</u></b>  | 3  |
| <b><u>ITEM 1.</u></b>  | <b><u>FINANCIAL STATEMENTS</u></b>   | 3  |
|                        | <b><u>UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS AT DECEMBER 31, 2010 AND MARCH 31, 2010</u></b>                                  | 3  |
|                        | <b><u>UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED DECEMBER 31, 2010 AND 2009</u></b> | 4  |
|                        | <b><u>UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE NINE MONTHS ENDED DECEMBER 31, 2010 AND 2009</u></b>           | 5  |
|                        | <b><u>NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u></b>   | 6  |
| <b><u>ITEM 2.</u></b>  | <b><u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u></b>                                    | 17 |
| <b><u>ITEM 3.</u></b>  | <b><u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u></b>   | 29 |
| <b><u>ITEM 4T.</u></b> | <b><u>CONTROLS AND PROCEDURES</u></b>  | 30 |
| <b><u>PART II.</u></b> | <b><u>OTHER INFORMATION</u></b>  | 30 |
| <b><u>ITEM 1.</u></b>  | <b><u>LEGAL PROCEEDINGS</u></b>  | 30 |
| <b><u>ITEM 1A.</u></b> | <b><u>RISK FACTORS</u></b>   | 30 |
| <b><u>ITEM 2.</u></b>  | <b><u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u></b>  | 39 |
| <b><u>ITEM 3.</u></b>  | <b><u>DEFAULTS UPON SENIOR SECURITIES</u></b>  | 39 |
| <b><u>ITEM 4.</u></b>  | <b><u>(REMOVED AND RESERVED)</u></b>   | 40 |
| <b><u>ITEM 5.</u></b>  | <b><u>OTHER INFORMATION</u></b>  | 40 |
| <b><u>ITEM 6.</u></b>  | <b><u>EXHIBITS</u></b>   | 40 |

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

## Edgar Filing: ITERIS, INC. - Form 10-Q

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

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Iteris, Inc.****Unaudited Condensed Consolidated Balance Sheets****(In thousands, except par value)**

|   | <b>December 31,<br/>2010</b> | <b>March 31,<br/>2010</b> |
|---|------------------------------|---------------------------|
| <b>Assets</b>   |                              |                           |
| Current assets:   |                              |                           |
| Cash and cash equivalents   | \$ 12,462                    | \$ 10,405                 |
| Trade accounts receivable   | 10,194                       | 11,311                    |
| Costs in excess of billings on uncompleted contracts  | 3,588                        | 3,871                     |
| Inventories   | 3,473                        | 2,727                     |
| Deferred income taxes   | 4,870                        | 4,993                     |
| Prepaid expenses and other current assets   | 504                          | 623                       |
| Total current assets  | 35,091                       | 33,930                    |
| Property and equipment, net   | 2,110                        | 2,550                     |
| Deferred income taxes   | 9,739                        | 9,739                     |
| Intangible assets, net  | 343                          | 452                       |
| Goodwill  | 19,821                       | 27,791                    |
| Other assets  | 204                          | 200                       |
| Total assets  | \$ 67,308                    | \$ 74,662                 |
| <b>Liabilities and stockholders' equity</b>   |                              |                           |
| Current liabilities:  |                              |                           |
| Trade accounts payable  | \$ 3,375                     | \$ 2,492                  |
| Accrued payroll and related expenses  | 2,618                        | 2,709                     |
| Accrued liabilities   | 1,782                        | 1,748                     |
| Billings in excess of costs and estimated earnings on uncompleted contracts   | 1,702                        | 2,105                     |
| Current portion of long-term debt   | 2,324                        | 2,324                     |
| Total current liabilities   | 11,801                       | 11,378                    |
| Deferred rent   | 1,142                        | 1,386                     |
| Unrecognized tax benefits   | 585                          | 751                       |
| Other non-current liabilities   |                              | 112                       |
| Long-term debt  | 1,097                        | 2,969                     |
| Total liabilities   | 14,625                       | 16,596                    |
| Commitments and contingencies   |                              |                           |
| Stockholders' equity:   |                              |                           |
| Common stock, \$0.10 par value, 70,000 shares authorized, 34,332 and 34,318 shares issued and outstanding at December 31, 2010 and March 31, 2010, respectively | 3,433                        | 3,432                     |
| Additional paid-in capital  | 137,807                      | 137,503                   |
| Accumulated deficit   | (88,557)                     | (82,869)                  |
| Total stockholders' equity  | 52,683                       | 58,066                    |
| Total liabilities and stockholders' equity  | \$ 67,308                    | \$ 74,662                 |

Edgar Filing: ITERIS, INC. - Form 10-Q

See accompanying notes.

Table of Contents

## Iteris, Inc.

## Unaudited Condensed Consolidated Statements of Operations

(In thousands, except per share amounts)

|   | Three Months Ended<br>December 31, |          | Nine Months Ended<br>December 31, |           |
|---|------------------------------------|----------|-----------------------------------|-----------|
|   | 2010                               | 2009     | 2010                              | 2009      |
| Net sales and contract revenues:          |                                    |          |                                   |           |
| Net sales                                 | \$ 8,608                           | \$ 7,401 | \$ 26,938                         | \$ 22,796 |
| Contract revenues                         | 5,424                              | 6,176    | 16,854                            | 20,280    |
| Total net sales and contract revenues     | 14,032                             | 13,577   | 43,792                            | 43,076    |
| Costs of net sales and contract revenues: |                                    |          |                                   |           |
| Cost of net sales                         | 4,352                              | 3,844    | 13,415                            | 12,099    |
| Cost of contract revenues                 | 3,929                              | 4,198    | 11,308                            | 13,290    |
| Gross profit                              | 5,751                              | 5,535    | 19,069                            | 17,687    |
| Operating expenses:                       |                                    |          |                                   |           |
| Selling, general and administrative       | 4,603                              | 3,915    | 13,515                            | 12,695    |
| Research and development                  | 882                                | 890      | 2,863                             | 2,738     |
| Impairment of goodwill                    | 7,970                              |          | 7,970                             |           |
| Amortization of intangible assets         | 36                                 | 36       | 109                               | 122       |
| Total operating expenses                  | 13,491                             | 4,841    | 24,457                            | 15,555    |
| Operating income (loss)                   | (7,740)                            | 694      | (5,388)                           | 2,132     |
| Non-operating income (expense):           |                                    |          |                                   |           |
| Other income (expense), net               | (7)                                | 25       | 13                                | 42        |
| Interest expense, net                     | (38)                               | (58)     | (120)                             | (215)     |
| Income (loss) before income taxes         | (7,785)                            | 661      | (5,495)                           | 1,959     |
| Benefit (provision) for income taxes      | 758                                | 48       | (193)                             | (563)     |
| Net income (loss)                         | \$ (7,027)                         | \$ 709   | \$ (5,688)                        | \$ 1,396  |
| Net income (loss) per share:              |                                    |          |                                   |           |
| Basic                                     | \$ (0.20)                          | \$ 0.02  | \$ (0.17)                         | \$ 0.04   |
| Diluted                                   | \$ (0.20)                          | \$ 0.02  | \$ (0.17)                         | \$ 0.04   |
| Weighted average shares outstanding:      |                                    |          |                                   |           |
| Basic                                     | 34,332                             | 34,260   | 34,331                            | 34,235    |
| Diluted                                   | 34,332                             | 34,469   | 34,331                            | 34,430    |

See accompanying notes.



Table of Contents

## Iteris, Inc.

## Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)

|   | Nine Months Ended<br>December 31, |          |
|---|-----------------------------------|----------|
|   | 2010                              | 2009     |
| <b>Cash flows from operating activities</b>                                       |                                   |          |
| Net income (loss)   | \$ (5,688)                        | \$ 1,396 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |          |
| Change in deferred tax assets   | 123                               | 574      |
| Depreciation of property and equipment  | 730                               | 742      |
| Stock-based compensation  | 286                               | 282      |
| Impairment of goodwill  | 7,970                             |          |
| Amortization of intangible assets   | 109                               | 122      |
| Loss on disposal of property and equipment  | 8                                 |          |
| Changes in operating assets and liabilities:                                      |                                   |          |
| Accounts receivable   | 1,117                             | 2,451    |
| Net costs and estimated earnings in excess of billings                            | (120)                             | (368)    |
| Inventories   | (746)                             | 2,478    |
| Prepaid expenses and other assets   | 115                               | (196)    |
| Accounts payable and accrued expenses   | 410                               | (2,569)  |
| Net cash provided by operating activities   | 4,314                             | 4,912    |
| <b>Cash flows from investing activities</b>                                       |                                   |          |
| Purchases of property and equipment   | (298)                             | (180)    |
| Cash paid for business combination  |                                   | (300)    |
| Net cash used in investing activities   | (298)                             | (480)    |
| <b>Cash flows from financing activities</b>                                       |                                   |          |
| Borrowings on long-term debt  |                                   | 750      |
| Payments on long-term debt  | (1,872)                           | (2,293)  |
| Deferred payment for prior business combination                                   | (106)                             |          |
| Proceeds from stock option exercises  | 19                                | 90       |
| Net cash used in financing activities   | (1,959)                           | (1,453)  |
| Effect of exchange rate changes on cash   |                                   | 53       |
| Increase in cash and cash equivalents   | 2,057                             | 3,032    |
| Cash and cash equivalents at beginning of period                                  | 10,405                            | 6,372    |
| Cash and cash equivalents at end of period  | \$ 12,462                         | \$ 9,404 |
| <b>Supplemental disclosure of non-cash investing and financing activities:</b>    |                                   |          |
| Liabilities incurred for business combination                                     | \$                                | \$ 218   |

See accompanying notes.

Table of Contents

**Iteris, Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements**

**December 31, 2010**

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

**Description of Business**

Iteris, Inc. (including our subsidiary, referred to collectively in these unaudited consolidated financial statements as Iteris, the Company, we, our and us ) is a leader in the traffic management market focused on the development and application of advanced technologies that reduce traffic congestion and improve the safety of surface transportation systems infrastructure. Additionally, we believe our products and services, in conjunction with sound traffic management, minimize the environmental impact of traffic congestion. By combining outdoor image processing, traffic engineering and information technology, we offer a broad range of Intelligent Transportation Systems ( ITS ) and driver safety solutions. Iteris was originally incorporated in Delaware in 1987.

**Basis of Presentation**

Our unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( U.S. GAAP ) 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 Iteris as of December 31, 2010, the consolidated results of operations for the three and nine months ended December 31, 2010 and 2009 and the consolidated cash flows for the nine months ended December 31, 2010 and 2009. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. The results of operations for the three and nine months ended December 31, 2010 are not necessarily indicative of those to be expected for future quarterly periods or the entire fiscal year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended March 31, 2010, which was filed with the SEC on May 21, 2010.

**Use of Estimates**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires our management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and 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, projections of taxable income used to assess realizability of deferred tax assets, inventory and warranty reserves, costs to complete long-term contracts, indirect cost rates used in cost-plus contracts, contract reserves, the valuation of debt and equity instruments and estimates of future cash flows used to

assess the recoverability of long-lived assets and the impairment of goodwill.

## **Revenue Recognition**

### *Net Sales*

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 we believe collectibility of the net sales amount is probable. Accordingly, at the date revenue is recognized, the significant uncertainties concerning the sale have been resolved.

We recognize revenue from the sale of deliverables that are part of a multiple-element arrangement in accordance with applicable accounting guidance that establishes a selling price hierarchy permitting the use of an estimated selling price to determine the allocation of arrangement consideration to a deliverable in a multiple-element arrangement where neither vendor specific objective evidence ( VSOE ) nor third-party evidence ( TPE ) is available for that deliverable. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, we are required to estimate the selling prices of those elements. Overall arrangement consideration is allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on our estimated selling prices.

Table of Contents

We account for multiple-element arrangements that consist only of software and software-related services in accordance with industry-specific accounting guidance for software and software-related transactions. For such transactions, revenue on arrangements that include multiple elements is allocated to each element based on the relative fair value of each element, and fair value is generally determined by VSOE. If we cannot objectively determine the fair value of any undelivered element included in such multiple-element arrangements and the only undelivered element is post-contract customer support or maintenance, and VSOE of the fair value of such support or maintenance does not exist, revenue from the entire arrangement is recognized ratably over the support period. When the fair value of a delivered element has not been established, but VSOE of fair value exists for the undelivered elements, we use the residual method to recognize revenue if the fair value of all undelivered elements is determinable. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue.

We also derive revenue from the provision of specific non-recurring contract engineering services and royalties. Non-recurring contract engineering revenues are recognized in the period in which the related services are performed. Royalty revenues are recorded in the period in which the royalty is earned based on unit sales of certain of our products. Non-recurring contract engineering and royalty revenues are included in net sales in the accompanying unaudited condensed consolidated statements of operations and totaled \$163,000 and \$459,000 for the three and nine months ended December 31, 2010, respectively, and \$124,000 and \$563,000 for the three and nine months ended December 31, 2009, respectively.

*Contract Revenues*

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 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.

**Foreign Currency**

We have determined that the functional currency of our subsidiary in Europe is the United States ( U.S. ) dollar. Local currency financial statements are remeasured into U.S. dollars at the exchange rate in effect as of the balance sheet date for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Revenues and expenses are remeasured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are remeasured using historical exchange rates. Remeasurement gains and losses are reported in other income (expense), net in the unaudited condensed consolidated statements of operations.

**Concentration of Credit Risk**

Financial instruments that potentially subject us to a concentration of credit risk consist principally of cash and cash equivalents and trade accounts receivable.

Cash and cash equivalents consist primarily of demand deposits and money market funds maintained with several financial institutions. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and are maintained with high credit quality financial institutions, and therefore have minimal credit risk.

Our accounts receivable are primarily derived from revenues earned from customers located throughout North America and Europe. We generally do not require collateral or other security from customers. We maintain an allowance for doubtful accounts for potential credit losses, which losses have generally been within management's expectations.

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

The fair value of cash and cash equivalents, receivables, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity. The fair value of line of credit agreements and long-term debt approximate carrying value because the related effective rates of interest approximate current market rates available to us for debt with similar terms and similar remaining maturities.

Table of Contents

**Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and short-term investments with initial maturities of ninety days or less.

**Allowance for Doubtful Accounts**

The collectability of our accounts receivable is evaluated through review of invoices outstanding greater than a certain period of time and ongoing credit evaluations of our customers' financial condition. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, we will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount we reasonably believe will be collected. We also maintain an allowance based on our historical collections experience. When we determine that collection is not likely, we write off accounts receivable against the allowance for doubtful accounts.

**Costs in Excess of Billings on Uncompleted Contracts**

Costs in excess of billings on uncompleted contracts in the accompanying unaudited condensed consolidated balance sheets represent unbilled amounts earned and reimbursable under services sales arrangements. At any given period-end, a large portion of the balance in this account represents the accumulation of labor, materials and other costs that have not been billed due to timing, whereby the accumulation of each month's costs and earnings are not administratively billed until the subsequent month. Also included in this account are amounts that become billable according to contract terms, which usually consider the passage of time, achievement of milestones or completion of the project. Generally, such unbilled amounts will be billed and collected within the next twelve months.

**Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts**

Billings in excess of costs and estimated earnings on uncompleted contracts in the accompanying unaudited condensed consolidated balance sheets is comprised of cash collected from customers and billings to customers on contracts in advance of work performed, advance payments negotiated as a contract condition, estimated losses on uncompleted contracts, project-related legal liabilities and other project-related reserves. The majority of the unearned amounts are expected to be earned within the next twelve months.

We record provisions for estimated losses on uncompleted contracts in the period in which such losses become known. The cumulative effects of revisions to contract revenues and estimated completion costs are recorded in the accounting period in which the amounts become evident and can be reasonably estimated. These revisions can include such items as the effects of change orders and claims, warranty claims, liquidated damages or other contractual penalties, adjustments for audit findings on U.S. or other government contracts and contract closeout settlements.

## **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 using the straight-line method over the estimated useful life ranging from three to eight years. Leasehold improvements are depreciated over the term of the related lease or the estimated useful life of the improvement, whichever is shorter.

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

Goodwill is tested for impairment on an annual basis in our fourth fiscal quarter or more frequently if indicators of impairment exist. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of our reporting units with each respective reporting unit's carrying amount, including goodwill. We determine the fair value of reporting units using the income approach with a reconciliation of the total reporting unit fair value to our total market capitalization plus an appropriate control premium. 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 and an impairment charge is recorded for any excess carrying amount over fair value. We performed annual impairment assessments of the carrying value of goodwill for each of the fiscal years ended March 31, 2010, 2009 and 2008. Based on these assessments, we determined that no impairment as of each of these dates was indicated as the estimated fair value of each of our reporting units exceeded its respective carrying value. We monitor the indicators for goodwill impairment testing between annual tests. Various circumstances including, among others, certain adverse business conditions impacting one or more reporting units or a decline in our market capitalization for an extended period of time, would cause us to test goodwill for impairment on an interim basis. Refer to Note 4 for additional discussion regarding our interim goodwill impairment analyses.

Table of Contents

We also evaluate long-lived assets used in operations for impairment when indicators of impairment are present. Reviews are performed to determine whether the carrying value of assets is impaired, based on a comparison of undiscounted expected future cash flows to the carrying value of the related net assets. 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 our 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**

We utilize the liability method of accounting for income taxes, whereby 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.

We must review all of our tax positions and make a determination as to whether each position is more-likely-than-not to be sustained upon examination by taxing authorities. If a tax position meets the more-likely-than-not standard, then the related tax benefit is measured based on a cumulative probability analysis of the amount that is more-likely-than-not to be realized upon effective settlement or disposition of the underlying issue.

**Stock-Based Compensation**

We record stock-based compensation in the unaudited consolidated statements of operations as an expense, based on the grant date fair values of our stock-based awards, whereby such fair values are amortized over the requisite service period. The fair value of our common stock option awards is estimated on the grant date using the Black-Scholes-Merton ( BSM ) option-pricing formula, which considers, among other factors, the expected life of the award and the expected volatility of our stock price. The fair value of our restricted stock units is based on the closing market price of our common stock on the date of grant.

**Research and Development Expenditures**

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

**Shipping and Handling Costs**

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



**Sales Taxes**

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

**Warranty**

We generally provide a one to three year warranty from the original invoice date on all products, materials and workmanship. Products sold to various original equipment manufacturer ( OEM ) customers sometimes carry longer warranties. Defective products will be either repaired or replaced, usually 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 liabilities in the accompanying unaudited condensed consolidated balance sheets.

**Repair and Maintenance Costs**

We incur repair and maintenance costs in the normal course of business. Should the activity result in a permanent improvement to one of our 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.

Table of Contents**Recent Accounting Pronouncements**

In October 2009, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2009-13, *Multiple-Deliverable Revenue Arrangements* ( ASU 2009-13 ), which amends the existing multiple-element revenue arrangements guidance currently included in Accounting Standards Codification ( ASC ) 605-25, *Revenue Recognition - Multiple Element Arrangements*. ASU 2009-13 provides for two significant changes to the existing multiple-element revenue arrangements guidance. The first relates to the determination of when the individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. The second change modifies the manner in which the transaction consideration is allocated across the separately identified deliverables. We adopted the amendments prescribed by ASU 2009-13 for our fiscal year beginning April 1, 2010 and such adoption did not have a material impact on our consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-14, *Certain Revenue Arrangements That Include Software Elements* ( ASU 2009-14 ), which amends and modifies the scope of ASC 985-605, *Software - Revenue Recognition*, such that many sales transactions of tangible products that include software and other related transactions will fall outside its scope. We adopted the amendments prescribed by ASU 2009-14 for our fiscal year beginning April 1, 2010 and such adoption did not have a material impact on our consolidated financial statements.

In December 2010, the FASB issued ASU No. 2010-29, *Disclosures of Supplementary Pro Forma Information for Business Combinations* ( ASU 2010-29 ), which amends certain existing, and adds additional, pro forma disclosure requirements for public companies under ASC 805, *Business Combinations*. We expect to adopt the amendments prescribed in ASU 2010-29 for business combinations for which the acquisition date is on or after our fiscal year beginning April 1, 2011. We do not expect such adoption to have a material impact on our consolidated financial statements.

**2. Supplemental Financial Information****Inventories**

The following table presents details of our inventories:

|                        | December 31,<br>2010 | March 31,<br>2010 |
|------------------------|----------------------|-------------------|
|                        | (In thousands)       |                   |
| Materials and supplies | \$ 2,609             | \$ 2,292          |
| Work in process        | 102                  | 49                |
| Finished goods         | 762                  | 386               |
|                        | \$ 3,473             | \$ 2,727          |

**Intangible Assets**

Edgar Filing: ITERIS, INC. - Form 10-Q

The following table presents details of our intangible assets:

|  | December 31, 2010     |                          | March 31, 2010        |                          |
|--|-----------------------|--------------------------|-----------------------|--------------------------|
|  | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| (In thousands)                             |                       |                          |                       |                          |
| Intangible assets subject to amortization: |                       |                          |                       |                          |
| Developed technology                       | \$ 996                | \$ (670)                 | \$ 996                | \$ (595)                 |
| Patents                                    | 317                   | (300)                    | 317                   | (266)                    |
| Total                                      | \$ 1,313              | \$ (970)                 | \$ 1,313              | \$ (861)                 |

As of December 31, 2010, future estimated amortization expense is as follows:

| Year Ending March 31: |        |
|-----------------------|--------|
| Remainder of 2011     | \$ 37  |
| 2012                  | 106    |
| 2013                  | 100    |
| 2014                  | 100    |
|                       | \$ 343 |

Table of Contents

If we acquire additional intangible assets in future periods, our amortization expense will increase.

**Goodwill**

The following table presents activity related to the carrying value of goodwill by reportable segment for the nine months ended December 31, 2010:

|   | Roadway<br>Sensors | Vehicle<br>Sensors | Transportation<br>Systems | Total     |
|---|--------------------|--------------------|---------------------------|-----------|
|   | (In thousands)     |                    |                           |           |
| Beginning balance   | \$ 8,214           | \$ 4,671           | \$ 14,906                 | \$ 27,791 |
| Impairment of Transportation<br>Systems goodwill (Note 4) |                    |                    | (7,970)                   | (7,970)   |
| Ending balance  | \$ 8,214           | \$ 4,671           | \$ 6,936                  | \$ 19,821 |

**Warranty Reserve Activity**

The following table presents activity related to the warranty reserve:

|                                    | Nine Months Ended<br>December 31, |        |
|------------------------------------|-----------------------------------|--------|
|                                    | 2010                              | 2009   |
|                                    | (In thousands)                    |        |
| Balance at beginning of period     | \$ 467                            | \$ 582 |
| Additions charged to cost of sales | 125                               | 102    |
| Warranty claims                    | (138)                             | (141)  |
| Balance at end of period           | \$ 454                            | \$ 543 |

**Net Income (Loss) Per Share**

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

|            | Three Months Ended<br>December 31,       |      | Nine Months Ended<br>December 31, |      |
|------------|--|------|-----------------------------------|------|
|            | 2010                                     | 2009 | 2010                              | 2009 |
|            | (In thousands, except per share amounts) |      |                                   |      |
| Numerator: |  |      |                                   |      |

Edgar Filing: ITERIS, INC. - Form 10-Q

|  |    |         |    |        |    |         |    |        |
|--|----|---------|----|--------|----|---------|----|--------|
| Net income (loss)  | \$ | (7,027) | \$ | 709    | \$ | (5,688) | \$ | 1,396  |
| Denominator:   |    |         |    |        |    |         |    |        |
| Weighted average common shares used in basic computation   |    | 34,332  |    | 34,260 |    | 34,331  |    | 34,235 |
| Dilutive stock options                                     |    |         |    | 208    |    |         |    | 194    |
| Dilutive warrants  |    |         |    | 1      |    |         |    | 1      |
| Weighted average common shares used in diluted computation |    | 34,332  |    | 34,469 |    | 34,331  |    | 34,430 |
| Net income (loss) per share:                               |    |         |    |        |    |         |    |        |
| Basic  | \$ | (0.20)  | \$ | 0.02   | \$ | (0.17)  | \$ | 0.04   |
| Diluted  | \$ | (0.20)  | \$ | 0.02   | \$ | (0.17)  | \$ | 0.04   |

Table of Contents

The following instruments were excluded from the computation of diluted net income (loss) per share as their effect would have been anti-dilutive:

|                        | Three Months Ended<br>December 31, |       | Nine Months Ended<br>December 31, |       |
|------------------------|------------------------------------|-------|-----------------------------------|-------|
|                        | 2010                               | 2009  | 2010                              | 2009  |
|                        | (In thousands)                     |       |                                   |       |
| Stock options          | 3,173                              | 1,095 | 1,690                             | 2,043 |
| Warrants               | 261                                | 335   | 281                               | 387   |
| Restricted stock units | 214                                |       | 71                                |       |

### 3. Fair Value Measurements

We measure fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Fair value measurements are based on a three-tier hierarchy that prioritizes the inputs used to measure fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets and liabilities; Level 2, defined as observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities or prices quoted in inactive markets; and Level 3, defined as unobservable inputs that are significant to the fair value of the asset or liability, and for which little or no market data exists, therefore requiring management to utilize its own assumptions to provide its best estimate of what market participants would use in valuing the asset or liability.

At December 31, 2010, we did not have any material financial assets or liabilities measured at fair value on a recurring basis using Level 3 inputs.

Our non-financial assets, such as goodwill, intangible assets and property and equipment, are measured at fair value on a non-recurring basis; generally when there is a transaction involving those assets such as a purchase transaction, a business combination or an adjustment for impairment. Other than goodwill, which was measured using certain Level 3 inputs (see Note 4), no non-financial assets were measured at fair value during the three and nine months ended December 31, 2010 and 2009.

### 4. Impairment of Goodwill

As discussed in Note 1, goodwill is tested for impairment on an annual basis in our fourth fiscal quarter or more frequently if indicators of impairment exist.

As of September 30, 2010, we performed the first step in the impairment analysis of the carrying value of goodwill for all reporting units primarily due to the decline in our stock price and market capitalization since our fiscal year ended March 31, 2010 and the ongoing weakness in the current economic environment. This analysis did not result in any impairment charges during the quarter ended September 30, 2010.

During the quarter ended December 31, 2010, due primarily to lower than expected operating results in our Transportation Systems reporting unit, as well as ongoing weakness specifically in the Transportation Systems markets, we determined it was necessary to perform another interim test of impairment of the carrying value of goodwill in our Transportation Systems reporting unit as of December 31, 2010. In performing the first step in this analysis, we estimated the fair value of our Transportation Systems reporting unit using the income approach. As of December 31, 2010, we determined that the carrying value of our Transportation Systems reporting unit exceeded its estimated fair value, and accordingly, we performed the second step of the impairment analysis to estimate the implied fair value of the goodwill of this reporting unit.

The implied fair value of goodwill was determined in the same manner utilized to estimate the amount of goodwill recognized in a business combination. To determine this value, we estimated the fair value of the assets and liabilities, including certain intangible assets, to be allocated to the Transportation Systems reporting unit as of December 31, 2010. The implied fair value of goodwill was measured as the difference between the estimated fair value of the reporting unit over the estimated fair value amounts of its assets and liabilities. The impairment loss for the Transportation Systems reporting unit was measured by the amount the carrying value of its goodwill exceeded the implied fair value of the goodwill. Accordingly, in order to write down Transportation Systems goodwill with a carrying value of \$14.9 million to its implied fair value of \$6.9 million, we recorded an impairment charge of \$8.0 million in the three months ended December 31, 2010.

Table of Contents

We estimated the fair value of the Transportation Systems reporting unit using the income approach, which was based on management's business plans and financial projections for the next five years, along with a perpetual growth rate thereafter of approximately 4%. The analysis also used a weighted average discount rate of approximately 14%, which we believe reflects our cost of capital, slightly adjusted for increased market risk.

Notwithstanding the impairment charge with respect to our Transportation Systems reporting unit described above, based on our interim analyses, we do not believe there are indicators of interim impairment of the Roadway Sensors or Vehicle Sensors reporting units as of December 31, 2010. We plan to perform our annual test for impairment of the carrying value of goodwill during the fourth fiscal quarter of our current fiscal year ending March 31, 2011.

**5. Revolving Line of Credit and Long-Term Debt**

**Revolving Line of Credit**

In September 2010, we entered into a modification agreement with California Bank & Trust to extend the expiration date of our revolving line of credit to October 1, 2012. The terms under this agreement are substantially similar to those of our prior agreement, whereby we may borrow up to \$12.0 million on our revolving line of credit. Interest on borrowed amounts under the revolving line of credit are payable monthly at a rate equal to the current stated prime rate (3.25% at December 31, 2010) up to the current stated prime rate plus 0.50%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under our credit facility (which includes our bank term note discussed below). We are obligated to pay an unused line fee of 0.25% per annum applied to the average unused portion of the revolving line of credit during the preceding month. The revolving line of credit does not contain any early termination fees and is secured by substantially all of our assets. As of December 31, 2010, no amounts were outstanding under the revolving line of credit portion of the facility.

**Long-Term Debt Bank Term Note**

As of December 31, 2010, we had outstanding borrowings of approximately \$3.4 million under our 48-month term note with California Bank & Trust. Principal payments under this term note are required to be repaid in 48 monthly installments of \$152,000 commencing on June 1, 2009. Additionally, beginning on November 1, 2009, and on November 1 of each year thereafter, we are required to repay additional principal of up to \$500,000, calculated based on certain financial measures, as further defined in the agreement. These additional principal payments effectively reduce the total number of monthly installments necessary to repay the term note. As of December 31, 2010 and March 31, 2010, an additional \$500,000 was included in the current portion of the term note within the accompanying unaudited condensed consolidated balance sheets, respectively representing the amount we estimate will be due on November 1, 2011 and the amount paid on November 1, 2010. Interest on the term note is payable monthly at a rate equal to the current stated prime rate plus 0.50% up to the current stated prime rate plus 1.00%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility. The term note contains no early termination fees and, along with the revolving line of credit under the same credit agreement, is secured by substantially all of our assets.

**6. Income Taxes**



## Edgar Filing: ITERIS, INC. - Form 10-Q

The following table sets forth our provision for income taxes, along with the corresponding effective tax rates:

|                                      | Three Months Ended<br>December 31, |        | Nine Months Ended<br>December 31, |          |
|--------------------------------------|------------------------------------|--------|-----------------------------------|----------|
|                                      | 2010                               | 2009   | 2010                              | 2009     |
|                                      | (In thousands, except percentages) |        |                                   |          |
| Benefit (provision) for income taxes | \$ 758                             | \$ 48  | \$ (193)                          | \$ (563) |
| Effective tax rate                   | (9.7)%                             | (7.3)% | 3.5%                              | 28.7%    |

During the three and nine months ended December 31, 2010, our effective tax rates were impacted unfavorably by a portion of the charge recorded for the impairment of goodwill (Note 4), amounting to approximately \$2.3 million, for which there is no corresponding tax basis. This unfavorable impact was partially offset by the impact of the recognition of approximately \$238,000 of previously unrecognized tax benefits during the current quarter due to the expiration of certain federal and state statutes in various jurisdictions. For the three and nine months ended December 31, 2009, our effective tax rates were favorably impacted by the recognition of approximately \$320,000 of unrecognized tax benefits during the three months ended December 31, 2009 due to the expiration of certain federal and state statutes in various jurisdictions.

On an interim basis, we estimate what our anticipated annual effective tax rate will be, while also separately considering applicable discrete and other non-recurring items, and record a quarterly income tax provision in accordance with the anticipated annual rate. As the fiscal year progresses, we refine our estimates based on actual events and financial results during the year. This process can result in significant changes to our expected effective tax rate. When this occurs, we adjust our income tax provision during the quarter in which our estimates are refined so that the year-to-date provision reflects the expected annual effective tax rate. These changes, along with adjustments to our deferred taxes, among others, may create fluctuations in our overall effective tax rate from quarter to quarter. We have not recorded any valuation allowance against our deferred tax assets as of December 31, 2010 and March 31, 2010.

Table of Contents

**7. Commitments and Contingencies**

**Litigation and Other Contingencies**

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

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

**Related Party Transaction**

In August 2009, MAXxess Systems, Inc. ( MAXxess ) executed a promissory note payable to Iteris for \$274,000 for amounts previously owed to us under a sublease agreement for which we had previously fully reserved such amount. MAXxess is owned by an investor group that includes two of our directors. As of December 31, 2010, all accrued interest has been paid and the entire \$274,000 principal balance was outstanding and payable to Iteris and remains fully reserved.

**8. Employee Benefit Plans**

We currently administer three separate stock incentive plans. Of these plans, we may only grant future awards from the 2007 Omnibus Incentive Plan (the 2007 Plan ). The 2007 Plan allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units ( RSUs ) and other stock-based awards. At December 31, 2010, there were 641,000 shares of common stock available for grant under the 2007 Plan.

**Stock Options**

A summary of activity with respect to our stock options for the nine months ended December 31, 2010 is as follows:

Edgar Filing: ITERIS, INC. - Form 10-Q

|  | Number of<br>Shares<br>(In thousands) |    | Weighted<br>Average<br>Exercise<br>Price<br>per Share |
|--|---------------------------------------|----|---|
| Options outstanding at March 31, 2010    | 3,218                                 | \$ | 1.77  |
| Granted                                  | 30                                    |    | 1.45  |
| Exercised                                | (14)                                  |    | 1.39  |
| Expired                                  | (63)                                  |    | 11.13   |
| Options outstanding at December 31, 2010 | 3,171                                 | \$ | 1.58  |

Included in the options outstanding at December 31, 2010 are vested options to purchase 769,000 shares of our common stock with an exercise price per share of \$1.19, which are scheduled to expire in September 2011 unless exercised prior to that date.

**Restricted Stock Units**

In August 2010, we granted 214,000 RSUs under the 2007 Plan to certain employees of Iteris, all of which were unvested and outstanding as of December 31, 2010. These RSUs are stock awards that entitle the holder to receive registered shares of our common stock upon vesting. The RSUs vest at the rate of 25% per year beginning in August 2011. The fair value per share of these RSUs was \$1.48, determined based on the closing market price of our common stock on the grant date.

Table of Contents**Stock-Based Compensation Expense**

The following table presents stock-based compensation expense that is included in each functional line item on our unaudited condensed consolidated statements of operations:

|   | Three Months Ended<br>December 31, |       | Nine Months Ended<br>December 31, |        |
|---|------------------------------------|-------|-----------------------------------|--------|
|   | 2010                               | 2009  | 2010                              | 2009   |
|   | (In thousands)                     |       |                                   |        |
| Cost of net sales                           | \$ 3                               | \$ 3  | \$ 8                              | \$ 7   |
| Cost of contract revenues                   | 9                                  | 10    | 26                                | 30     |
| Selling, general and administrative expense | 78                                 | 75    | 227                               | 225    |
| Research and development expense            | 10                                 | 7     | 25                                | 20     |
|   | \$ 100                             | \$ 95 | \$ 286                            | \$ 282 |

At December 31, 2010, there was approximately \$719,000 of unrecognized compensation expense related to unvested stock options and RSUs. This expense is currently expected to be recognized over a weighted average period of approximately 2.6 years. If there are any modifications or cancellations of the underlying unvested awards, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense. Future stock-based compensation expense and unearned stock-based compensation will increase to the extent that we grant additional stock options, RSUs or other stock-based awards.

The grant date fair value per share of stock options granted in the nine months ended December 31, 2010 has been estimated using the following weighted average assumptions:

|  |         |
|--|---------|
| Expected life - years                            | 7       |
| Risk-free interest rate                          | 2.1%    |
| Expected volatility of common stock              | 58%     |
| Dividend yield                                   |         |
| Weighted-average grant date fair value per share | \$ 0.86 |

**9. Common Stock Warrants**

The following table summarizes information regarding outstanding warrants to purchase shares of our common stock as of December 31, 2010:

| Exercise Price per Share | Warrants Outstanding<br>(In thousands) | Remaining Contractual Life<br>(Years) |
|--------------------------|--|---------------------------------------|
| \$ 1.42                  | 15                                     | 2.7                                   |

|      |     |     |
|------|-----|-----|
| 3.25 | 246 | 0.2 |
|      | 261 |     |

All of the outstanding warrants were exercisable at December 31, 2010.

#### **10. Business Segment Information**

We currently operate in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage and VersiCam vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. This segment also includes our Pico compact video detection system, which was designed primarily to respond to international video detection needs. The Vehicle Sensors segment includes our lane departure warning products and is comprised of all of our activities related to vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Certain corporate expenses, including interest and amortization of 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.

Edgar Filing: ITERIS, INC. - Form 10-Q

Table of Contents

The following table sets forth selected unaudited consolidated financial information for our reportable segments for the three and nine months ended December 31, 2010 and 2009:

|   | Roadway<br>Sensors | Vehicle<br>Sensors | Transportation<br>Systems | Total     |
|---|--------------------|--------------------|---------------------------|-----------|
|   | (In thousands)     |                    |                           |           |
| <b>Three Months Ended<br/>December 31, 2010</b> |                    |                    |                           |           |
| Product revenue                                 | \$ 6,529           | \$ 1,916           | \$                        | \$ 8,445  |
| Service and other revenue                       |                    | 163                | 5,424                     | 5,587     |
| Stock-based compensation                        | 15                 | 4                  | 19                        | 38        |
| Depreciation and amortization                   | 53                 | 20                 | 47                        | 120       |
| Impairment of goodwill                          |                    |                    | 7,970                     | 7,970     |
| Segment income (loss)                           | 797                | (86)               | (8,354)                   | (7,643)   |
| <b>Three Months Ended<br/>December 31, 2009</b> |                    |                    |                           |           |
| Product revenue                                 | \$ 5,734           | \$ 1,543           | \$                        | \$ 7,277  |
| Service and other revenue                       |                    | 124                | 6,176                     | 6,300     |
| Stock-based compensation                        | 10                 | 7                  | 16                        | 33        |
| Depreciation and amortization                   | 57                 | 24                 | 54                        | 135       |
| Segment income (loss)                           | 582                | (74)               | 283                       | 791       |
| <b>Nine Months Ended<br/>December 31, 2010</b>  |                    |                    |                           |           |
| Product revenue                                 | \$ 21,470          | \$ 5,009           | \$                        | \$ 26,479 |
| Service and other revenue                       |                    | 459                | 16,854                    | 17,313    |
| Stock-based compensation                        | 36                 | 15                 | 50                        | 101       |
| Depreciation and amortization                   | 166                | 62                 | 145                       | 373       |
| Impairment of goodwill                          |                    |                    | 7,970                     | 7,970     |
| Segment income (loss)                           | 3,377              | (592)              | (7,876)                   | (5,091)   |
| <b>Nine Months Ended<br/>December 31, 2009</b>  |                    |                    |                           |           |
| Product revenue                                 | \$ 18,691          | \$ 3,542           | \$                        | \$ 22,233 |
| Service and other revenue                       |                    | 563                | 20,280                    | 20,843    |
| Stock-based compensation                        | 28                 | 23                 | 46                        | 97        |
| Depreciation and amortization                   | 176                | 64                 | 168                       | 408       |
| Segment income (loss)                           | 2,126              | (910)              | 1,207                     | 2,423     |

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

|  | Three Months Ended<br>December 31, |        | Nine Months Ended<br>December 31, |          |
|--|------------------------------------|--------|-----------------------------------|----------|
|  | 2010                               | 2009   | 2010                              | 2009     |
|  | (In thousands)                     |        |                                   |          |
| <b>Segment income (loss):</b>                |                                    |        |                                   |          |
| Total income (loss) from reportable segments | \$ (7,643)                         | \$ 791 | \$ (5,091)                        | \$ 2,423 |
| <b>Unallocated amounts:</b>                  |                                    |        |                                   |          |
| Corporate and other expenses                 | (61)                               | (61)   | (188)                             | (169)    |

Edgar Filing: ITERIS, INC. - Form 10-Q

|                                   |            |        |            |          |
|-----------------------------------|------------|--------|------------|----------|
| Amortization of intangible assets | (36)       | (36)   | (109)      | (122)    |
| Other income (expense), net       | (7)        | 25     | 13         | 42       |
| Interest expense, net             | (38)       | (58)   | (120)      | (215)    |
| Income (loss) before income taxes | \$ (7,785) | \$ 661 | \$ (5,495) | \$ 1,959 |

Table of Contents

**11. Subsequent Event**

On January 3, 2011 (the Closing), we acquired all of the capital stock of Meridian Environmental Technology, Inc. (MET), a privately-held company based in Grand Forks, North Dakota. MET specializes in 511 advanced traveler information systems, as well as Maintenance Decision Support System management tools that allow users to create solutions to meet roadway maintenance decision needs. Our primary reasons for the acquisition were (i) to enhance our ability to provide travelers and traffic management authorities with more accurate and real-time information and network performance management tools and (ii) to provide Iteris with key capabilities in the emerging performance measurement and management market.

In connection with the acquisition, we paid approximately \$1.5 million in cash at the Closing, which is subject to certain post-closing adjustments pursuant to the stock purchase agreement. We also agreed to pay up to \$1 million on each of the first two anniversaries of the Closing, subject to certain adjustments related to the retention of various key employees and certain other adjustments as further defined in the agreement. Additionally, we may pay up to an additional \$1 million per year for two years pursuant to an earn-out provision, based on revenue and operating income achieved from MET's operations during the twelve months ending December 31, 2011 and 2012. We are currently in the process of performing the initial accounting for this business combination, including measuring the fair value of the consideration transferred (including contingent consideration) and identifying and measuring the gross amount and fair value of the assets acquired and liabilities assumed, which we expect to complete in the quarter ending March 31, 2011. Supplemental pro forma information is not presented as the necessary analysis has not yet been performed on MET's historical financial information.

**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 growth, sales, revenue, expenses, profits, capital needs, competition, development plans, and manufacturing capabilities, the applications for and acceptance of our products and services, and the status of our facilities and product development. These statements are not guarantees of future performance and are subject to certain risks and uncertainties that could cause our actual results to differ materially from those projected. You should not place undue reliance on these forward-looking statements that speak only as of the date hereof. We 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, including to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.*

**Overview**

**General.** We are a leader in the traffic management market focused on the development and application of advanced technologies that reduce traffic congestion and improve the safety of surface transportation systems infrastructure. Additionally, we believe our products and services, in conjunction with sound traffic management, minimize the environmental impact of traffic congestion. By combining outdoor image processing, traffic engineering and information technology, we offer a broad range of Intelligent Transportation Systems (ITS) and driver safety solutions to customers in the United States (U.S.) and internationally.



**Business Segments.** We currently operate in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage, VersiCam and Pico vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications, as well as our Abacus family of products. The Vehicle Sensors segment includes our lane departure warning ( LDW ) products, including our AutoVue LDW system, and is comprised of all of our activities related to in-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.

*Roadway Sensors*

Our Roadway Sensors segment product line uses advanced image processing technology to capture and analyze video images through sophisticated algorithms, enabling vehicle detection and transmission of both video images and data using various communication technologies.

- Our Vantage video detection systems detect vehicle presence at intersections, as well as vehicle count, speed and other traffic data used in traffic management systems. Our Vantage systems give traffic managers the ability to mitigate roadway congestion by modifying traffic signal timing or detecting incidents quickly.

Table of Contents

- VersiCam, our integrated camera and processor video detection system, is a cost-efficient video detection system for smaller intersections that require only a few detection points.
- Pico, our compact video detection system, was developed primarily to address international video detection needs, and was designed for easy installation and configuration.
- Our Abacus products take advantage of the large number of existing installed closed-circuit television video feeds monitoring roadways, signalized intersections, tunnels and bridges to allow for data collection and incident detection without the set-up and calibration generally required with other systems.

We believe that future growth domestically and internationally, particularly in developing countries, will be dependent in part on the continued adoption of above-ground video detection technologies, instead of traditional in-pavement loop technology, to manage traffic.

*Vehicle Sensors*

Our Vehicle Sensors segment addresses the leading cause of roadway fatalities: lane change, roadway departure and rear-end collision accidents. We developed the world's first production LDW system and offer a proven system that is available as an original equipment manufacturer (OEM) and aftermarket option on heavy trucks worldwide and as an option in certain passenger cars. Our LDW products utilize video detection images to detect when a vehicle begins to drift toward an unintended lane change. When this occurs, the unit automatically emits a distinctive rumble strip or other audible warning sound, alerting the driver to make a correction. We believe that as a result of the expected 2013 European Union (EU) mandate for LDW and other active safety systems, and an overall awareness of the potential benefits of LDW, that we will experience an even higher degree of competition from a variety of tier-one OEM suppliers and other potential market entrants worldwide. While we believe that this increased competition validates the long-term market opportunity for LDW systems in commercial vehicles, it could also adversely affect our future LDW sales and margins. We are currently working with our European OEM customer base to establish long-term supply agreements that extend to 2013 and beyond in order to meet the anticipated increase in demand; however, we cannot assure you that our efforts will be successful or that the increase in demand will occur. We have entered into an exclusive license of our LDW technology to our strategic partner, Valeo Schalter and Sensuren GmbH (Valeo), for the passenger car market. Recently, we and our partner have experienced a greater degree of competition in the passenger car market, as several passenger car OEMs have introduced vehicle platforms with competing LDW systems. However, Valeo continues to pursue opportunities in the passenger car market.

In addition to our LDW systems, our Vehicle Sensors portfolio includes radar-based Forward Collision Warning (FCW) and Blind Spot Warning (BSW) systems for the North American truck market, and our SafetyDirect product, a system that reports driver performance data captured by our LDW system, and has the ability to relay this data directly to fleet operators through integration with the truck's existing fleet communications system. We expect future revenues generated by our SafetyDirect product will be based on a subscription model, whereby we charge our customers a monthly fee based on the number of vehicles equipped with the product. We offer the FCW and BSW features through the resale of Delphi's radar-based systems, for which we are the exclusive North American dealer, while SafetyDirect was internally developed. These products, together with our LDW products, combine to create a suite of active safety driver assistance features focused on reducing the number of motor vehicle crashes and the severity of crash-related injuries.

*Transportation Systems*

Our Transportation Systems segment includes transportation engineering and consulting services focused on the planning, design, development and implementation of software-based systems that integrate sensors, video surveillance, computers, and advanced communications equipment to enable public agencies to monitor, control and direct traffic flow, assist in the quick dispatch of emergency crews and distribute real-time information about traffic conditions. Our services include planning, design and implementation of surface transportation infrastructure systems. We perform analysis and study goods movement, commercial vehicle operations, travel demand forecasting and systems engineering, and identify mitigation measures to reduce traffic congestion. Historically, these services and systems have primarily been sold to local, state and national transportation agencies in the United States under a broad range of fixed price and cost plus fixed fee contracts; however, in the fiscal year ended March 31, 2010 ( fiscal 2010 ), we began work on our first two overseas contract awards and plan to pursue additional international opportunities for our Transportation Systems segment.

Our Transportation Systems segment is largely dependent upon governmental funding and is affected by state and local budgetary issues. We believe the overall expansion of our Transportation Systems segment in the future will at least in part be dependent on the passage of a new Federal Highway Bill, which Congress is currently working on. We anticipate continued delays in the enactment of such a new bill, and until such time as a bill becomes law, the allotment of transportation funds in federal, state and local budgets may be uncertain. We believe that prolonged uncertainty has and may continue to adversely impact our net sales and contract revenues and our overall financial performance in future periods.

Table of Contents

**Acquisitions.** In January 2011, we acquired all of the capital stock of Meridian Environmental Technology, Inc. ( MET ), for an initial payment of approximately \$1.5 million. MET was a privately-held company based in Grand Forks, North Dakota, and specializes in 511 advanced traveler information systems, as well as Maintenance Decision Support System management tools that allow users to create solutions to meet roadway maintenance decision needs. We also agreed to pay up to \$1 million on each of the first two anniversaries of the closing of the acquisition, as well as up to an additional \$2 million under a 24-month earn-out provision. Refer to Note 11 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report for additional discussion on this acquisition.

In April 2009, we completed the acquisition of certain assets of Hamilton Signal, which included the Abacus system, for an aggregate purchase price of approximately \$518,000.

**Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our unaudited consolidated financial statements included herein, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the collectibility of accounts receivable, the valuation of inventories, the recoverability of long-lived assets and goodwill, the realizability of deferred tax assets, accounting for stock-based compensation, the valuation of equity instruments, warranty reserves and other contingencies. We base these estimates on 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 accounting policies that affect our more significant judgments and estimates used in the preparation of our unaudited condensed consolidated financial statements are those relating to revenue recognition, accounts receivable, inventory, goodwill, warranty, income taxes, and stock-based compensation. These policies are described in further detail in our Annual Report on Form 10-K for fiscal 2010. There have been no significant changes in our critical accounting policies and estimates during the nine months ended December 31, 2010 as compared to what was previously disclosed in our Annual Report on Form 10-K for fiscal 2010, except for our revenue recognition policy, which has been updated as follows:

**Revenue Recognition.** We record product revenues (net sales) 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.

We recognize revenue from the sale of deliverables that are part of a multiple-element arrangement in accordance with applicable accounting guidance that establishes a selling price hierarchy permitting the use of an estimated selling price to determine the allocation of arrangement consideration to a deliverable in a multiple-element arrangement where neither vendor specific objective evidence ( VSOE ) nor third-party evidence ( TPE ) is available for that deliverable. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, we are required to estimate the selling prices of those elements. Overall arrangement consideration is allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether

those selling prices are evidenced by VSOE or TPE or are based on our estimated selling prices.

We account for multiple-element arrangements that consist only of software and software-related services in accordance with industry-specific accounting guidance for software and software-related transactions. For such transactions, revenue on arrangements that include multiple elements is allocated to each element based on the relative fair value of each element, and fair value is generally determined by VSOE. If we cannot objectively determine the fair value of any undelivered element included in such multiple-element arrangements and the only undelivered element is post-contract customer support or maintenance, and VSOE of the fair value of such support or maintenance does not exist, revenue from the entire arrangement is recognized ratably over the support period. When the fair value of a delivered element has not been established, but VSOE of fair value exists for the undelivered elements, we use the residual method to recognize revenue if the fair value of all undelivered elements is determinable. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue.

Table of Contents

We also derive revenue from the provision of specific non-recurring contract engineering services to our strategic partner, Valeo, related to our LDW systems, and royalties earned on unit sales of our LDW systems by Valeo to the passenger car market. 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. Non-recurring contract engineering revenues and royalty revenues are included in our net sales.

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

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. Under the percentage of completion method, recognition of profit is dependent upon the accuracy of a variety of estimates, including engineering progress, materials quantities, and achievement of milestones, incentives, penalty provisions, labor productivity, cost estimates and others. Such estimates are based on various professional judgments we make with respect to those factors and are subject to change as the project proceeds and new information becomes available.

**Recent Accounting Pronouncements**

Refer to Note 1 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report for a discussion of recent accounting pronouncements.

Table of Contents**Results of Operations**

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

|   | Three Months Ended<br>December 31, |        | Nine Months Ended<br>December 31, |        |
|---|------------------------------------|--------|-----------------------------------|--------|
|   | 2010                               | 2009   | 2010                              | 2009   |
| Net sales and contract revenues:          |                                    |        |                                   |        |
| Net sales                                 | 61.3%                              | 54.5%  | 61.5%                             | 52.9%  |
| Contract revenues                         | 38.7                               | 45.5   | 38.5                              | 47.1   |
| Total net sales and contract revenues     | 100.0%                             | 100.0% | 100.0%                            | 100.0% |
| Costs of net sales and contract revenues: |                                    |        |                                   |        |
| Cost of net sales                         | 31.0                               | 28.3   | 30.6                              | 28.1   |
| Cost of contract revenues                 | 28.0                               | 30.9   | 25.8                              | 30.9   |
| Gross profit                              | 41.0                               | 40.8   | 43.5                              | 41.1   |
| Operating expenses:                       |                                    |        |                                   |        |
| Selling, general and administrative       | 32.8                               | 28.8   | 30.9                              | 29.5   |
| Research and development                  | 6.3                                | 6.6    | 6.5                               | 6.4    |
| Impairment of goodwill                    | 56.8                               |        | 18.2                              |        |
| Amortization of intangible assets         | 0.3                                | 0.3    | 0.2                               | 0.3    |
| Total operating expenses                  | 96.1                               | 35.7   | 55.8                              | 36.1   |
| Operating income (loss)                   | (55.2)                             | 5.1    | (12.3)                            | 4.9    |
| Non-operating income (expense):           |                                    |        |                                   |        |
| Other income (expense), net               | (0.0)                              | 0.2    | 0.0                               | 0.1    |
| Interest expense, net                     | (0.3)                              | (0.4)  | (0.3)                             | (0.5)  |
| Income (loss) before income taxes         | (55.5)                             | 4.9    | (12.5)                            | 4.5    |
| Benefit (provision) for income taxes      | 5.4                                | 0.4    | (0.4)                             | (1.3)  |
| Net income (loss)                         | (50.1)%                            | 5.2%   | (13.0)%                           | 3.2%   |

**Analysis of Quarterly Results of Operations**

*Net Sales and Contract Revenues.* Net sales are comprised of product sales from our Roadway Sensors and Vehicle Sensors segments, as well as contract engineering revenue and royalty revenue generated from our Vehicle Sensors segment. Contract revenues consist entirely of revenues from our Transportation Systems segment, which are generated from systems integration and ITS consulting services primarily with federal, state, county and municipal agencies.

## Edgar Filing: ITERIS, INC. - Form 10-Q

### Table of Contents

The following tables present details of our net sales and contract revenues for the three and nine months ended December 31, 2010 and 2009:

|   | <b>Three Months Ended<br/>December 31,</b> |             | <b>Increase<br/>(Decrease)</b> | <b>%<br/>Change</b> |
|---|--|-------------|--------------------------------|---------------------|
|   | <b>2010</b>                                | <b>2009</b> |                                |                     |
| <b>(In thousands, except percentages)</b> |  |             |                                |                     |
| Roadway Sensors                           | \$ 6,529                                   | \$ 5,734    | \$ 795                         | 13.9%               |
| Vehicle Sensors                           | 2,079                                      | 1,667       | 412                            | 24.7                |
| Net sales                                 | 8,608                                      | 7,401       | 1,207                          | 16.3                |
| Contract revenues                         | 5,424                                      | 6,176       | (752)                          | (12.2)              |
| Total net sales and contract revenues     | \$ 14,032                                  | \$ 13,577   | \$ 455                         | 3.4%                |

|   | <b>Nine Months Ended<br/>December 31,</b> |             | <b>Increase<br/>(Decrease)</b> | <b>%<br/>Change</b> |
|---|---|-------------|--------------------------------|---------------------|
|   | <b>2010</b>                               | <b>2009</b> |                                |                     |
| <b>(In thousands, except percentages)</b> |   |             |                                |                     |
| Roadway Sensors                           | \$ 21,470                                 | \$ 18,691   | \$ 2,779                       | 14.9%               |
| Vehicle Sensors                           | 5,468                                     | 4,105       | 1,363                          | 33.2                |
| Net sales                                 | 26,938                                    | 22,796      | 4,142                          | 18.2                |
| Contract revenues                         | 16,854                                    | 20,280      | (3,426)                        | (16.9)              |
| Total net sales and contract revenues     | \$ 43,792                                 | \$ 43,076   | \$ 716                         | 1.7%                |

We have historically had a diverse customer base. For the nine months ended December 31, 2010 and 2009, no individual customer represented greater than 10% of our total net sales and contract revenues.

#### *Roadway Sensors*

The increases in Roadway Sensors net sales for the three and nine months ended December 31, 2010 as compared to the corresponding periods in the prior year were driven by higher unit sales domestically from both our direct sales and dealer markets which was offset in part by lower prices due to competitive pressures. In the current period, we also saw particular strength, both domestically and internationally, in certain of our newer product lines which were introduced within the last 12 to 18 months. Additionally, we believe we have recently gained market share as a result of these new product introductions. However, we cannot assure that these new products will continue to gain market share or new products we develop in the future will be as successful. In the prior year periods, especially in the first quarter, we experienced significantly lower sales primarily as a result of the downturn in the overall economy, which brought declines in commercial and residential construction, reductions and delays in spending on infrastructure projects and government budgetary pressures.

#### *Vehicle Sensors*

Vehicle Sensors net sales were primarily made up of sales of our LDW systems to the heavy truck market, which aggregated approximately \$1.9 million and \$5.0 million for the three and nine months ended December 31, 2010, respectively, compared to \$1.5 million and \$3.5 million for the three and nine months ended December 31, 2009, respectively. In the prior year, we experienced a significant slowdown in overall LDW unit



## Edgar Filing: ITERIS, INC. - Form 10-Q

shipments to each of our key markets, driven largely by the weakness in the U.S. and worldwide economy at that time. Comparatively, in the current year periods, we have seen relatively higher unit sales, particularly to our foreign OEM heavy truck customers in Europe and Japan, as well as to our domestic truck fleet customers. Although we have seen improvements in our sales in the current year, as compared to the prior year, we remain cautious in our outlook for the remainder of the current fiscal year and beyond. We anticipate that Vehicle Sensors unit sales in future periods could be adversely impacted by, among other factors, slower than expected adoption rates of our LDW system across each of our target markets and the continuing uncertainty in the global economic environment. Additionally, future unit sales of LDW systems and unit pricing could be adversely impacted as a result of increased competition in this market.

Also included in Vehicle Sensors net sales are revenues from contract engineering services and royalty revenues in the passenger car market that are derived from our strategic relationship with Valeo, which aggregated approximately \$163,000 and \$459,000 for the three and nine months ended December 31, 2010, respectively, compared to \$124,000 and \$563,000 for the three and nine months ended December 31, 2009, respectively. The net overall decline in the current fiscal year was primarily the result of continued decreases in contract engineering services provided to Valeo as the pertinent engineering development activities have generally reached maturity for the related vehicle platforms that currently incorporate our LDW system. The decrease in contract engineering services provided was partially offset by an increase in our royalty revenues in the current fiscal year as compared to the prior fiscal year. Our LDW systems are currently offered as an option on four Infiniti models. While Valeo is promoting our LDW systems to other passenger car OEMs, we cannot assure you that Valeo will be successful in these efforts.

Table of Contents*Contract Revenues*

Contract revenues are primarily dependent upon the continued availability of funding at the local, state and federal levels from the various agencies and departments of transportation. For the three and nine months ended December 31, 2010, the decrease in our contract revenues compared to the corresponding periods in the prior year was primarily the result of the ongoing weakness in the Transportation Systems markets, which has been aggravated by a general lengthening of the overall sales cycle, from the bid and proposal process, to the signing of a contract and commencement of work on a project, as well as government budgeting constraints and funding delays on certain existing contracts. In the prior year periods, we experienced higher revenues from several large contracts which also contained higher than usual amounts of sub-consulting content. In the future, we plan to continue to pursue large contracts that may contain significant sub-consulting content, which will likely contribute to variability in the timing and amount of our contract revenues from period to period.

*Gross Profit.* The following tables present details of our gross profit for the three and nine months ended December 31, 2010 and 2009:

|  | Three Months Ended<br>December 31, |          | Increase | %<br>Change |
|--|------------------------------------|----------|----------|-------------|
|  | 2010                               | 2009     |          |             |
|  | (In thousands, except percentages) |          |          |             |
| Total gross profit   | \$ 5,751                           | \$ 5,535 | \$ 216   | 3.9%        |
| Total gross profit as a % of<br>total net sales and contract<br>revenues | 41.0%                              | 40.8%    |          |             |
| Gross profit as a % of net<br>sales                                      | 49.4%                              | 48.1%    |          |             |
| Gross profit as a % of<br>contract revenues                              | 27.6%                              | 32.0%    |          |             |

|  | Nine Months Ended<br>December 31,  |           | Increase | %<br>Change |
|--|------------------------------------|-----------|----------|-------------|
|  | 2010                               | 2009      |          |             |
|  | (In thousands, except percentages) |           |          |             |
| Total gross profit   | \$ 19,069                          | \$ 17,687 | \$ 1,382 | 7.8%        |
| Total gross profit as a % of<br>total net sales and contract<br>revenues | 43.5%                              | 41.1%     |          |             |
| Gross profit as a % of net<br>sales                                      | 50.2%                              | 46.9%     |          |             |
| Gross profit as a % of<br>contract revenues                              | 32.9%                              | 34.5%     |          |             |

Our total gross profit and total gross profit as a percent of total net sales and contract revenues increased for the nine months ended December 31, 2010 as compared to the corresponding period in the prior year primarily as a result of our product and service mix, whereby product net sales represented approximately 62% of our total net sales and contract revenues in the current period as compared to only 53% in the prior year period. Our product net sales generally carry higher margins than our contract revenues derived from our consulting services.

## Edgar Filing: ITERIS, INC. - Form 10-Q

The increase in gross profit as a percent of net sales ( gross margin ) for the three and nine months ended December 31, 2010 as compared to the corresponding periods in the prior year was primarily a result of higher overall net sales and margins in Roadway Sensors during the current year. Such higher margins were largely driven by our customer mix and lower costs for certain key materials. We generally enjoy higher gross margins on direct sales as compared to dealer and aftermarket sales. In Vehicle Sensors, we also experienced a significant improvement in our year over year gross margins as a result of both (i) overall higher product sales levels in the current period which provided for improved overhead absorption and (ii) higher royalty revenues from Valeo. Additionally, in the prior year periods, we recorded certain estimates for excess and obsolete inventory in our Vehicle Sensors segment, which adversely affected our gross margins in that period. Gross profit as a percentage of net sales can fluctuate in any specific quarter or year based on, among other factors, customer and product mix, competitive pricing requirements, product warranty costs and provisions for excess and obsolete inventories, as well as possible shifts of engineering resources from development activities to sustaining activities, which we record as cost of goods sold.

Table of Contents

We recognize contract revenues and related gross profit using percentage of completion contract accounting, and the underlying mix of contract activity affects the related gross profit recognized in any given period. Gross profit as a percent of contract revenues for the three months ended December 31, 2010 was down considerably from the comparable prior year period primarily due to lower overall revenues in the current quarter, as well as the result of various paid holidays during the current quarter. In the current nine month period, gross profit as a percent of contract revenues was slightly lower than the prior year period primarily due to the effects from the current three month period described directly above. We expect the variability and related timing of contract mix and related sub-consulting content in our Transportation Systems contracts in future periods, as well as paid holidays and other factors, will continue to cause fluctuations in this segment's gross margins from period to period.

*Selling, General and Administrative Expense.* The following tables present selling, general and administrative expense for the three and nine months ended December 31, 2010 and 2009:

|                                     | Three Months Ended<br>December 31, 2010 |   | Three Months Ended<br>December 31, 2009          |   | Increase<br>(Decrease) | %<br>Change |
|-------------------------------------|---|---|--|---|------------------------|-------------|
|                                     | Amount                                  | % of Net<br>Sales and<br>Contract<br>Revenues | Amount<br><br>(In thousands, except percentages) | % of Net<br>Sales and<br>Contract<br>Revenues |                        |             |
| Salary and personnel-related        | \$ 3,134                                | 22.3%   | \$ 2,611   | 19.2%   | \$ 523                 | 20.0%       |
| Facilities, insurance and supplies  | 532                                     | 3.8   | 436  | 3.2   | 96                     | 22.0        |
| Travel and conferences              | 421                                     | 3.0   | 346  | 2.5   | 75                     | 21.7        |
| Professional and outside services   | 337                                     | 2.4   | 205  | 1.5   | 132                    | 64.4        |
| Other                               | 179                                     | 1.3   | 317  | 2.3   | (138)                  | (43.5)      |
| Selling, general and administrative | \$ 4,603                                | 32.8%   | \$ 3,915   | 28.8%   | \$ 688                 | 17.6%       |

|                                     | Nine Months Ended<br>December 31, 2010 |   | Nine Months Ended<br>December 31, 2009           |   | Increase<br>(Decrease) | %<br>Change |
|-------------------------------------|--|---|--|---|------------------------|-------------|
|                                     | Amount                                 | % of Net<br>Sales and<br>Contract<br>Revenues | Amount<br><br>(In thousands, except percentages) | % of Net<br>Sales and<br>Contract<br>Revenues |                        |             |
| Salary and personnel-related        | \$ 9,368                               | 21.4%   | \$ 8,518   | 19.8%   | \$ 850                 | 10.0%       |
| Facilities, insurance and supplies  | 1,747                                  | 4.0   | 1,708  | 4.0   | 39                     | 2.3         |
| Travel and conferences              | 1,166                                  | 2.7   | 1,042  | 2.4   | 124                    | 11.9        |
| Professional and outside services   | 1,063                                  | 2.4   | 794  | 1.8   | 269                    | 33.9        |
| Other                               | 171                                    | 0.4   | 633  | 1.5   | (462)                  | (73.0)      |
| Selling, general and administrative | \$ 13,515                              | 30.9%   | \$ 12,695  | 29.5%   | \$ 820                 | 6.5%        |

The overall increase in selling, general and administrative expense for the three and nine months ended December 31, 2010 compared to the corresponding periods in the prior year was primarily due to (i) higher selling and commission-related expenses for our Roadway Sensors and Vehicle Sensors segments, as total net sales for both segments collectively increased approximately 16% and 18%, respectively, from the prior year periods, (ii) higher salary and headcount-related expenses as we have added certain key sales and marketing personnel in all three of our

## Edgar Filing: ITERIS, INC. - Form 10-Q

business segments, (iii) additional consulting and outside services expenses in the Vehicle Sensors segment related to market research and certain other sales and marketing activities and (iv) additional legal and professional services related to our acquisition of MET, along with various other corporate initiatives. We also saw a shift from cost of sales to sales and marketing of certain of our headcount expenses in our Transportation Systems segment in the current year commensurate with the overall decline in this segment's revenues and the reallocation of existing personnel in an effort to expand our contract backlog and increase contract revenues. However, we cannot assure that our efforts will be successful. Additionally, in the nine months ended December 31, 2010, we realized approximately \$250,000 in reversals of previously recorded bad debt expense (included in the Other category in the table above) as a result of collecting certain large accounts receivable balances. In prior periods, we had recorded an estimated allowance for doubtful accounts against these receivables given the uncertainty of collection at that time. In the future, our operating results in any given period may be favorably or adversely impacted as a result of our estimates of the realization of our accounts receivable. We currently expect our total selling, general and administrative expenses for the current fiscal year and future periods to be higher in absolute dollars when compared to recent prior year periods mainly as a result of our company-wide efforts to expand our Roadway Sensors net sales and Transportation Systems contract revenues, both domestically and internationally, and gain market share.

Table of Contents

*Research and Development Expense.* The following tables present research and development expense for the three and nine months ended December 31, 2010 and 2009:

|   | Three Months Ended<br>December 31, 2010 |   | Three Months Ended<br>December 31, 2009 |   | Increase<br>(Decrease) | %<br>Change |
|---|---|---|---|---|------------------------|-------------|
|   | Amount                                  | % of Net<br>Sales and<br>Contract<br>Revenues | Amount                                  | % of Net<br>Sales and<br>Contract<br>Revenues |                        |             |
|   | (In thousands, except percentages)      |   |   |   |                        |             |
| Salary and<br>personnel-related<br>Facilities,<br>development and<br>supplies | \$ 562                                  | 4.0%  | \$ 613                                  | 4.5%  | \$ (51)                | (8.3)%      |
| Other   | 239                                     | 1.7   | 245                                     | 1.8   | (6)                    | (2.4)       |
| Other   | 81                                      | 0.6   | 32                                      | 0.2   | 49                     | 153.1       |
| Research and<br>development   | \$ 882                                  | 6.3%  | \$ 890                                  | 6.6%  | \$ (8)                 | (0.9)%      |

|   | Nine Months Ended<br>December 31, 2010 |   | Nine Months Ended<br>December 31, 2009 |   | Increase<br>(Decrease) | %<br>Change |
|---|--|---|--|---|------------------------|-------------|
|   | Amount                                 | % of Net<br>Sales and<br>Contract<br>Revenues | Amount                                 | % of Net<br>Sales and<br>Contract<br>Revenues |                        |             |
|   | (In thousands, except percentages)     |   |  |   |                        |             |
| Salary and<br>personnel-related<br>Facilities,<br>development and<br>supplies | \$ 1,778                               | 4.1%  | \$ 1,957                               | 4.5%  | \$ (179)               | (9.1)%      |
| Other   | 920                                    | 2.1   | 676                                    | 1.6   | 244                    | 36.1        |
| Other   | 165                                    | 0.4   | 105                                    | 0.2   | 60                     | 57.1        |
| Research and<br>development   | \$ 2,863                               | 6.5%  | \$ 2,738                               | 6.4%  | \$ 125                 | 4.6%        |

Table of Contents

Research and development expenses for the nine months ended December 31, 2010 were, in total, higher than for the corresponding period in the prior year due primarily due to additional development and related activities associated with our Vehicle Sensors segment. We currently expect our total research and development expenditures for the current fiscal year will be slightly higher when compared to the prior fiscal year.

*Impairment of Goodwill.* As discussed in Note 1 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report, goodwill is tested for impairment on an annual basis in our fourth fiscal quarter or more frequently if indicators of impairment exist.

As of September 30, 2010, we performed the first step in the impairment analysis of the carrying value of goodwill for all reporting units primarily due to the decline in our stock price and market capitalization since our fiscal year ended March 31, 2010 and the ongoing weakness in the current economic environment. This analysis did not result in any impairment charges during the quarter ended September 30, 2010.

During the quarter ended December 31, 2010, due primarily to lower than expected operating results in our Transportation Systems reporting unit, as well as ongoing weakness specifically in the Transportation Systems markets, we determined it was necessary to perform another interim test of impairment of the carrying value of goodwill in our Transportation Systems reporting unit as of December 31, 2010. In performing the first step in this analysis, we estimated the fair value of our Transportation Systems reporting unit using the income approach. As of December 31, 2010, we determined that the carrying value of our Transportation Systems reporting unit exceeded its estimated fair value, and accordingly, we performed the second step of the impairment analysis to estimate the implied fair value of the goodwill of this reporting unit.

The implied fair value of goodwill was determined in the same manner utilized to estimate the amount of goodwill recognized in a business combination. To determine this value, we estimated the fair value of the assets and liabilities, including certain intangible assets, to be allocated to the Transportation Systems reporting unit as of December 31, 2010. The implied fair value of goodwill was measured as the difference between the estimated fair value of the reporting unit over the estimated fair value amounts of its assets and liabilities. The impairment loss for the Transportation Systems reporting unit was measured by the amount the carrying value of its goodwill exceeded the implied fair value of the goodwill. Accordingly, in order to write down Transportation Systems goodwill with a carrying value of \$14.9 million to its implied fair value of \$6.9 million, we recorded an impairment charge of \$8.0 million in the three months ended December 31, 2010.

We estimated the fair value of the Transportation Systems reporting unit using the income approach, which was based on management's business plans and financial projections for the next five years, along with a perpetual growth rate thereafter of approximately 4%. The analysis also used a weighted average discount rate of approximately 14%, which we believe reflects our cost of capital, slightly adjusted for increased market risk.

Our Transportation Systems segment has recently been adversely impacted by, among other factors, (i) continued delays in government spending and resolution of budgetary issues, (ii) longer than expected lead times in bidding, successfully winning and commencing work on new contracts, and renewing existing contracts, and (iii) the ongoing weakness in the macroeconomic environment and the longer than expected economic recovery. In the future, the value of goodwill attributable to our Transportation Systems or other reporting units could be adversely impacted by, among other factors, declines in our financial results or market capitalization for an extended period of time, or our failure to meet financial performance projections included in our forecasts of future operating results.

## Edgar Filing: ITERIS, INC. - Form 10-Q

Notwithstanding the impairment charge with respect to our Transportation Systems reporting unit described above, based on our interim analyses, we do not believe there are indicators of interim impairment of the Roadway Sensors or Vehicle Sensors reporting units as of December 31, 2010. We plan to perform our annual test for impairment of the carrying value of goodwill during the fourth fiscal quarter of our current fiscal year ending March 31, 2011.

*Interest Expense, Net.* Net interest expense of \$38,000 and \$120,000 for the three and nine months ended December 31, 2010, respectively, was lower than the \$58,000 and \$215,000 for the three and nine months ended December 31, 2009, respectively, due to the overall lower level of borrowings in the current fiscal year, as we continue to make monthly principal payments on our term note. We currently anticipate our interest expense will continue to decline for the remainder of the fiscal year ending March 31, 2011. See [Liquidity and Capital Resources](#) below for additional details on our borrowings.



Table of Contents

*Income Taxes.* The following tables present our provision for income taxes for the three and nine months ended December 31, 2010 and 2009:

|                                      | Three Months Ended<br>December 31, |        |        | Increase | %<br>Change |
|--------------------------------------|------------------------------------|--------|--------|----------|-------------|
|                                      | 2010                               | 2009   |        |          |             |
|                                      | (In thousands, except percentages) |        |        |          |             |
| Benefit (provision) for income taxes | \$ 758                             | \$ 48  | \$ 710 | 1,479%   |             |
| Effective tax rate                   | (9.7)%                             | (7.3)% |        |          |             |

|                                      | Nine Months Ended<br>December 31,  |          |        | Decrease | %<br>Change |
|--------------------------------------|------------------------------------|----------|--------|----------|-------------|
|                                      | 2010                               | 2009     |        |          |             |
|                                      | (In thousands, except percentages) |          |        |          |             |
| Benefit (provision) for income taxes | \$ (193)                           | \$ (563) | \$ 370 | (66)%    |             |
| Effective tax rate                   | 3.5%                               | 28.7%    |        |          |             |

During the three and nine months ended December 31, 2010, our effective tax rates were impacted unfavorably by a portion of the charge recorded for the impairment of goodwill, amounting to approximately \$2.3 million, for which there is no corresponding tax basis. This unfavorable impact was partially offset by the impact of the recognition of approximately \$238,000 of previously unrecognized tax benefits during the current quarter due to the expiration of certain federal and state statutes in various jurisdictions. For the three and nine months ended December 31, 2009, our effective tax rates were favorably impacted by the recognition of approximately \$320,000 of unrecognized tax benefits during the three months ended December 31, 2009 due to the expiration of certain federal and state statutes in various jurisdictions.

On an interim basis, we estimate what our anticipated annual effective tax rate will be, while also separately considering applicable discrete and other non-recurring items, and record a quarterly income tax provision in accordance with the anticipated annual rate. As the fiscal year progresses, we refine our estimates based on actual events and financial results during the year. This process can result in significant changes to our expected effective tax rate. When this occurs, we adjust our income tax provision during the quarter in which our estimates are refined so that the year-to-date provision reflects the expected annual effective tax rate. These changes, along with adjustments to our deferred taxes, among others, may create fluctuations in our overall effective tax rate from quarter to quarter. We have not recorded any valuation allowance against our deferred tax assets as of December 31, 2010 and March 31, 2010.

Table of Contents**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 the availability of borrowings on a line of credit facility to fund our operations, which we believe to be sufficient to fund our operations for at least the next twelve months. However, we may need or choose to raise additional capital to fund potential future acquisitions and our future growth. We may raise such funds by selling equity or debt securities to the public or to selected investors, or by borrowing money from financial institutions. If we raise additional funds by issuing equity or convertible debt securities, our existing stockholders may experience significant dilution and any equity securities that may be issued may have rights senior to our existing stockholders.

At December 31, 2010, we had \$23.3 million in working capital, which included no borrowings on our \$12.0 million line of credit and \$12.5 million in cash and cash equivalents. This compares to working capital of \$22.6 million at March 31, 2010, which included no borrowings on our line of credit and \$10.4 million in cash and cash equivalents.

The following table summarizes our cash flows for the nine months ended December 31, 2010 and 2009:

|  | <b>Nine Months Ended<br/>December 31,</b> |             |
|--|---|-------------|
|  | <b>2010</b>                               | <b>2009</b> |
|  | <b>(In thousands)</b>                     |             |
| <b>Net cash provided by (used in):</b> |   |             |
| Operating activities                   | \$ 4,314                                  | \$ 4,912    |
| Investing activities                   | (298)                                     | (480)       |
| Financing activities                   | (1,959)                                   | (1,453)     |

*Operating Activities.* Cash provided by our operations for the nine months ended December 31, 2010 was the result of our net loss of \$5.7 million, which was offset by (i) \$9.2 million in non-cash items within the statement of operations, primarily \$8.0 million for the impairment of goodwill and depreciation expense of \$730,000; and (ii) \$776,000 in cash resulting from changes in our operating assets and liabilities during the period. Cash provided by operating activities during the nine months ended December 31, 2009 was primarily the result of (i) our net income during that period of \$1.4 million; (ii) \$1.7 million in non-cash items within the statement of operations, primarily adjustments to our deferred tax assets and depreciation expense; and (iii) \$1.8 million in cash resulting from changes in operating assets and liabilities during the period.

Our net accounts receivable decreased approximately \$1.1 million, or 10%, from March 31, 2010 to December 31, 2010 due primarily to (i) lower overall net sales and contract revenues in the current fiscal year, driven by lower Transportation Systems contract revenues and (ii) larger than expected cash collections near the end of the current quarter.

## Edgar Filing: ITERIS, INC. - Form 10-Q

Our inventories increased approximately 27% from March 31, 2010 to December 31, 2010 as we have built up certain inventories on hand to meet anticipated increases in our product net sales in both Roadway Sensors and Vehicle Sensors. In the future, our inventory levels are likely to continue to be determined based upon, among other factors, the level of purchase orders we receive from our customers, the stage at which our products are in their respective product life cycles, and competitive situations in the marketplace. We attempt to balance such considerations against risk of obsolescence and potentially excess inventory levels.

The increase in accounts payable by approximately 35% from March 31, 2010 to December 31, 2010 was driven by our increased inventory levels and the general timing of payments to vendors.

*Investing Activities.* Cash used in our investing activities during the nine months ended December 31, 2010 consisted of \$298,000 for purchases of property and equipment. Cash used in investing activities for the nine months ended December 31, 2009 consisted of purchases of property and equipment of \$180,000, as well as \$300,000 used for the Hamilton Signal acquisition in April 2009.

*Financing Activities.* Net cash used in financing activities during the nine months ended December 31, 2010 was the result of (i) \$1.9 million in payments on our long-term debt and (ii) \$106,000 representing the first anniversary payment for the acquisition of certain assets of Hamilton Signal. These payments were partially offset during the period by \$19,000 in proceeds received from the exercise of outstanding stock options to purchase shares of our common stock. In April 2011, we expect to make the final payment of \$112,000 related to the Hamilton Signal acquisition. During the nine months ended December 31, 2009, cash used in financing activities was the result of net payments on our long-term debt of \$1.5 million, partially offset by \$90,000 in proceeds received from the exercise of outstanding stock options to purchase shares of our common stock.

Table of Contents

*Borrowings*

In October 2008, we entered into a \$19.5 million credit facility with California Bank & Trust (the Bank), which provides for a two-year revolving line of credit with borrowings of up to \$12.0 million and a \$7.5 million 48-month term note (discussed below). In September 2010, we entered into a modification agreement with the Bank to extend the expiration date of our revolving line of credit to October 1, 2012. Interest on borrowed amounts under the revolving line of credit are payable monthly at a rate equal to the current stated prime rate (3.25% at December 31, 2010) up to the current stated prime rate plus 0.50%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility. We are obligated to pay an unused line fee of 0.25% per annum applied to the average unused portion of the revolving line of credit during the preceding month. The revolving line of credit does not contain any early termination fees and is secured by substantially all of our assets. As of December 31, 2010, no amounts were outstanding under the revolving line of credit portion of the facility. Availability under this line of credit may be reduced or otherwise limited as a result of our obligations to comply with certain financial covenants, as described further below.

As of December 31, 2010, we had outstanding borrowings of approximately \$3.4 million under the term note included in our credit facility. Principal payments under this term note are required to be repaid in 48 monthly installments of \$152,000 commencing on June 1, 2009. Additionally, beginning on November 1, 2009, and on November 1 of each year thereafter, we are required to repay additional principal of up to \$500,000, calculated based on certain financial measures, as further defined in the loan agreement. These additional principal payments effectively reduce the total number of monthly installments necessary to repay the term note. To date, we have made additional principal payments of \$500,000 on November 1, 2010 and 2009, respectively. Interest on the term note is payable monthly at a rate equal to the current stated prime rate plus 0.50% up to the current stated prime rate plus 1.00%, depending on aggregate deposit balances maintained at the bank in relation to the total loan commitment under the credit facility. The term note contains no early termination fees and, along with our revolving line of credit discussed above, is secured by substantially all of our assets.

In connection with our credit facility and loan agreement with the Bank, we are also required to comply with certain quarterly financial covenants. These include achieving ratios for working capital and debt service, as well as maintaining a level of profitability, all of which are further defined in the agreement. While we believe we are currently in compliance with all such financial covenants, we cannot assure you that we will not violate one or more covenants in the future. If we were to be in violation of covenants under this agreement, our lender could choose to accelerate payment on all outstanding loan balances and pursue its security interest in our assets. In this event, we cannot assure you that we would be able to quickly obtain equivalent or suitable replacement financing on acceptable terms, on a timely basis, or at all. If we were not able to secure alternative sources of financing, such acceleration would have a material adverse impact on our business and financial condition.

**Off Balance Sheet Arrangements**

Other than our operating leases, we do not believe we have any other material off balance sheet arrangements at December 31, 2010.

**Seasonality**

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

inclement weather conditions.

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

#### **Interest Rate Risk**

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

#### **Foreign Currency Risk**

To date, a small portion of our net sales have been denominated in Euros. Gains or losses from foreign currency remeasurement are included in other income (expense), net in our consolidated financial statements and to date have not been significant. We do not believe we are currently exposed to any material risk of loss from currency exchange fluctuations. We do not currently purchase derivative financial instruments to hedge foreign currency exchange risk, but may do so in the future.

Table of Contents

**ITEM 4T. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

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

**Changes in Internal Controls**

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

**Inherent Limitations on Internal Control**

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, 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 management override or improper acts, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple errors. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to management override, error or improper acts may occur and not be detected. Any resulting misstatement or loss may have an adverse and material effect on our business, financial condition and results of operations.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The information set forth under the heading "Litigation and Other Contingencies" in Note 7 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report, is incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

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

Table of Contents

**The economic slowdown has reduced and delayed government funding for transportation infrastructure projects and initiatives, decreased availability of financial capital for our customers and has adversely impacted real estate development, all of which has adversely impacted our net sales and contract revenues.** Decreased consumer spending, the failure of certain financial institutions and businesses, concerns about the availability and cost of credit, and reduced corporate profits and capital spending have resulted in a downturn in worldwide economic conditions, as well as budgetary shortfalls increasingly present at all levels of government. These unfavorable economic conditions are having a negative impact on customer orders and government funding of infrastructure projects incorporating our products and services. Such factors have and may continue to result in cancellations and rescheduling of backlog and customer orders. In addition, the recent decline in the U.S. real estate market, particularly in new home and commercial construction, has adversely impacted new road construction and in the prior fiscal year resulted in flat or declining Roadway Sensor and Vehicle Sensor net sales and also adversely impacted Transportation Systems contract revenues. Any of the foregoing economic conditions may adversely affect our net sales and contract revenues in future periods and make it extremely difficult for our customers, our suppliers and us to accurately forecast and plan future business activities. Additionally, there continues to be uncertainties regarding the impact of the federal stimulus package and the fact that the accessibility of funds is taking longer than originally anticipated, as well as a delay in the passage of a new Federal Highway Bill. If such conditions continue or worsen, our business, financial condition and results of operations could be materially and adversely affected.

**Because we depend on government contracts and subcontracts, we face additional risks related to contracting with federal, state and local governments, including budgetary issues and fixed price contracts.** 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 45%, 45% and 38% of our total net sales and contract revenues for the fiscal years ended March 31, 2010, 2009 and 2008, respectively. We anticipate that revenue from government contracts will continue to remain a significant portion of our net sales and contract revenues. Government business is, in general, subject to special risks and challenges, including:

- delays in funding, including delays in the allocation of funds to state and local agencies from the U.S. federal government as a result of the expiration of the 2005 Federal Highway Bill on October 31, 2009, as well as delays or reductions in stimulus funds and other state and local funding dedicated for transportation projects;
- other government budgetary constraints, cut-backs, delays or reallocation of government funding;
- performance bond requirements;
- long purchase cycles or approval processes;
- competitive bidding and qualification requirements;
- changes in government policies and political agendas;



## Edgar Filing: ITERIS, INC. - Form 10-Q

- milestone requirements and liquidated damage provisions for failure to meet contract milestones; and
- international conflicts or other military operations that could cause the temporary or permanent diversion of government funding from transportation or other infrastructure projects.

Governmental budgets and plans are subject to change without warning. Certain risks of selling to governmental entities include dependence on appropriations and administrative allocation of funds, changes in governmental procurement legislation and regulations and other policies that may reflect political developments or agendas, significant changes in contract scheduling, intense competition for government business and termination of purchase decisions for the convenience of the governmental entity. Substantial delays in purchase decisions by governmental entities, and the current constraints on government budgets at the federal, state and local level, could cause our net sales and contract revenues and income to drop substantially or to fluctuate significantly between fiscal periods.

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 period. 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.

Table of Contents

**California state budgetary constraints may have a material adverse impact on us.** The state of California has experienced, and is continuing to experience, a significant budget shortfall and other related budgetary issues and constraints. The state of California has historically been and is considered to be a key geographic region for our Roadway Sensors and Transportation Systems segments. Ongoing uncertainty as to the timing and accessibility of budgetary funding, changes in state funding allocations to local agencies and municipalities, or other delays in purchasing for, or commencement of, transportation projects has and may continue to have a negative impact on our net sales and contract revenues and our income.

**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.

In Vehicle Sensors, we believe that as a result of the expected 2013 European mandate for LDW and other active safety systems, and an overall awareness of the potential benefits of LDW, we will experience an even higher degree of competition from a variety of tier-one OEM suppliers and other potential market entrants worldwide. We also expect such competition to increase due to technological advancements, industry consolidations and reduced barriers to entry. Increased competition is likely to result in a loss of market share, price reductions and reduced gross margins, any of which could seriously harm our business, financial condition and results of operations. Additionally, awareness of LDW technology is increasing and other market players have developed competing technologies, which may contain improvements or added features beyond those offered by our LDW systems. Additionally, from time to time, we may be required to re-compete for LDW business from our main customer base of heavy truck OEMs. These OEMs could make a supplier change based on price, product performance or available features. Should our competition be successful, this could adversely affect our ability to successfully market and sell our LDW systems to new and existing customers.

We compete with existing, well-established companies in our Roadway Sensors segment, both domestically and abroad. Certain technological barriers to entry make it difficult for new competitors to enter the market with competing video or other technologies; however, we are aware of new market entrants from time to time. Increased competition could result in loss of market share, price reductions and reduced gross margins, any of which could seriously harm our business, financial condition and results of operations.

The Transportation Systems market is highly fragmented and is subject to evolving national and regional quality and safety standards. Our competitors vary in size, number, scope and breadth of the products and services they offer, and include large multi-national engineering firms and smaller local regional firms.

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

**We may 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.** In January 2011, we completed the acquisition of Meridian Environmental Technology, Inc. We also completed the acquisition of certain assets of Hamilton Signal in April 2009. We have in

## Edgar Filing: ITERIS, INC. - Form 10-Q

the past acquired, and may in the future acquire, additional 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;

Table of Contents

- 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 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 officers, or any of our other executives or key members of management could adversely affect our business, financial condition, or results of operations. Our success will also depend in large part upon our ability to continue to attract, retain and motivate qualified engineering and other highly skilled technical personnel. In particular, the future success of our Transportation Systems segment will depend on our ability to hire additional qualified engineers and planners. Competition for qualified employees, particularly development engineers, is intense. We may not be able to continue to attract and retain sufficient numbers of such highly skilled employees. Our inability to attract and retain additional key employees or the loss of one or more of our current key employees could adversely affect our business, financial condition and results of operations.

**Our profitability could be adversely affected if we are not able to maintain adequate utilization of our Transportation Systems workforce.** The cost of providing our Transportation Systems engineering and consulting services, including the extent to which we utilize our workforce, affects our profitability. The rate at which we utilize our workforce is affected by a number of factors, including:

- our ability to transition employees from completed projects to new assignments and to hire and assimilate new employees;
- our ability to forecast demand for our services and thereby maintain an appropriate headcount in our various regions;
- our need to devote time and resources to training, business development, professional development and other non-chargeable activities; and
- our ability to match the skill sets of our employees to the needs of the marketplace.

**Our use of the percentage of completion method of accounting for our contract revenues could result in a reduction or reversal of previously recorded revenues and profits.** A significant portion of our total net sales and contract revenues are measured and recognized using the percentage of completion method of accounting. Our use of this accounting method results in recognition of revenues and profits ratably over the life of a contract, based generally on the proportion of costs incurred to date to total costs expected to be incurred for the entire project. The effects of revisions to revenues and estimated costs are recorded when the amounts are known or can be reasonably estimated. Such revisions could occur in any period and their effects could be material. Although we have historically made reasonably reliable estimates of the progress towards completion of long-term engineering, program management, construction management or construction contracts, the uncertainties inherent in the estimating process make it possible for actual costs to vary materially from estimates, including reductions or reversals of previously recorded revenues and profits.

**Our failure to successfully bid on new contracts and renew existing contracts could reduce our revenues and profits.** Our business depends on our ability to successfully bid on new contracts and renew existing contracts with private and public sector customers. Contract proposals and negotiations are complex and frequently involve a lengthy bidding and selection process, which are affected by a number of factors, such as market conditions, financing arrangements and required governmental approvals. For example, a customer may require us to provide a surety bond or letter of credit to protect the client should we fail to perform under the terms of the contract. If negative market conditions continue, or if we fail to secure adequate financial arrangements or the required governmental approval, we may not be able to pursue particular projects, which could adversely reduce or eliminate our profitability.

**We may experience production gaps that could materially and adversely impact our sales and financial results and the ultimate acceptance of our products.** It is possible that we could experience unforeseen quality control issues or part shortages as we adjust production to meet current demand for our products. We have historically used single suppliers for certain significant components in our products. Should any such delay or disruption occur, or should a key supplier discontinue operations because of the current economic climate, our future sales will likely be materially and adversely affected. Additionally, we rely heavily on select

Table of Contents

contract manufacturers to produce many of our products and do not have any long-term contracts to guarantee supply of such 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 for many of our products, if necessary, we could experience a production gap if for any reason our contract manufacturers were unable to meet our production requirements and our cost of goods sold could increase, adversely affecting our margins.

**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 production 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, our ability to 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 LDW systems in the passenger car market. The success of our LDW system will also depend in part on the success of the automotive vehicles that incorporate our technology, as well as the success of optional equipment that OEMs bundle with our technologies.

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

**New environmental regulations may result in a decline in our Vehicle Sensors net sales.** From time to time, environmental regulations are enacted, which can significantly increase the cost of manufacturing new vehicles as well as the cost of maintaining existing vehicles and truck fleets. As a result, we could experience a decline in sales of our Vehicle Sensors products as truck and vehicle manufacturers and fleet operators attempt to control their costs.

**We depend upon Valeo to market our LDW technologies for the OEM passenger car market.** We have granted Valeo the exclusive right to sell and manufacture our LDW system to the worldwide passenger car market in exchange for royalty payments for each LDW unit sold. As such, the future success and broad market acceptance of our technologies in the passenger car market will depend upon Valeo's ability to manufacture, market and sell our technologies, and to convince more OEM passenger car manufacturers to adopt our technologies. To date, we have not generated significant royalties from Valeo's efforts and have only been designed into one passenger car OEM product line. If Valeo does not devote considerable resources and aggressively pursue opportunities, our expansion into the passenger car market, and our related revenues from contract engineering services and royalty revenues, could be adversely affected or not materialize as originally anticipated.

**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 pressures in the marketplace as technologies mature;

Table of Contents

- changes in customer requirements;
- additional qualification requirements related to new products or components;
- frequent new product introductions and enhancements;
- inventory issues related to transition to new or enhanced models; and
- evolving industry standards and changes in the regulatory environment.

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

**Our international business operations may be threatened by many factors that are outside of our control.** While we historically have had limited international sales and operations experience, we began work on our first overseas contracts in Abu Dhabi and Dubai in fiscal 2010. We plan to expand our international efforts in the future with respect to all three of our segments, but cannot assure you that we will be successful in those efforts. International operations subject us to various inherent risks including, among others:

- currency fluctuations and restrictions;
- political, social and economic instability, as well as international conflicts and acts of terrorism;
- longer accounts receivable payment cycles;
- import and export license requirements and restrictions of the United States and each other country in which we operate;



## Edgar Filing: ITERIS, INC. - Form 10-Q

- 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.

Substantially 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 currently 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. Additionally, as we pursue the expansion of our international business, certain fixed and other overhead costs could outpace our revenues, thus adversely affecting our results of operations. We may likewise face local competitors in certain international markets who are more established, have greater economies of scale and stronger customer relationships. Furthermore, as we increase our international sales, our total revenues may also be affected to a greater extent by seasonal fluctuations resulting from lower sales that typically occur during the summer months in Europe and other parts of the world.

**If our internal controls over financial reporting do not comply with the requirements of the Sarbanes-Oxley Act, our business and stock price could be adversely affected.** Section 404 of the Sarbanes-Oxley Act of 2002 currently requires us to evaluate the effectiveness of our internal controls over financial reporting at the end of each fiscal year and to include a management report assessing the effectiveness of our internal controls over financial reporting in all annual reports.

Table of Contents

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. Section 989G of the Act added Section 404(c) to the Sarbanes-Oxley Act of 2002, which permanently exempts small public companies that qualify as either a Non-Accelerated Filer or Smaller Reporting Company from the auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act. Likewise, in September 2010, the SEC issued a Final Rule, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports for Non-Accelerated Filers*, to conform its rules and forms with the new Section 404(c). For our fiscal year ending March 31, 2011, we will be exempt from the auditor attestation requirement over our internal control over financial reporting; however, to the extent we do not qualify as a Non-Accelerated Filer or Smaller Reporting Company in subsequent fiscal years, we will be subject to such auditor attestation requirement. In such an event, we may not be able to complete the work required for such attestation on a timely basis, and even if we timely complete such requirements, our independent registered public accounting firm may still conclude that our internal controls over financial reporting are not effective.

Our management, including our CEO and CFO, does not expect that our internal controls over financial reporting will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Iteris have been or will be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. 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.

**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:

- delays in government contracts and funding from time to time and budgetary constraints at the federal, state and local levels;
- our ability to access stimulus funding, funding from a new Federal Highway Bill or other funding;
- declines in new home and commercial real estate construction and related road and other infrastructure construction;
- 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;

## Edgar Filing: ITERIS, INC. - Form 10-Q

- the long lead times associated with government contracts or required by vehicle manufacturers;
- the size, timing, rescheduling or cancellation of significant customer orders;
- our ability to control costs;
- our ability to raise additional capital;
- the mix of our products and services sold in a quarter, which mix has varied and is expected to continue to vary from time to time;
- seasonality due to winter weather conditions;
- 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 introduction of new products by competitors;

Table of Contents

- 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; and
- international conflicts and acts of terrorism.

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.

**As compared to recent prior fiscal years, we experienced a decline in our net sales and contract revenues in our most recently completed fiscal year ended March 31, 2010. If we fail to manage this decline effectively, we may be unable to execute our business plan and may experience future weaknesses in our operating results.** We have expanded our overall business in the past few years; however, we

experienced a reduction in our net sales and contract revenues in the fiscal year ended March 31, 2010. Based on our business objectives, and in order to achieve future growth, we will need to continue to add additional qualified personnel, and invest in additional research and development and sales and marketing activities, which could lead to increases in our expenses and further declines in our operating results. In addition, our past expansion has placed, and future expansion is expected to place, a significant strain on our managerial, administrative, operational, financial and other resources. If we are unable to manage these activities or any unexpected revenue declines successfully, our growth, our business, our financial condition and our results of operations could continue to be adversely affected.

**We may not be able to adequately protect or enforce our intellectual property rights, which could harm our competitive position.** If we are not able to adequately protect or enforce the proprietary aspects of our technology, competitors could be able to access our proprietary technology and our business, financial condition and results of operations will likely be seriously harmed. We currently attempt to protect our technology through a combination of patent, copyright, trademark and trade secret laws, employee and third party nondisclosure agreements and similar means. Despite our efforts, other parties may attempt to disclose, obtain or use our technologies or systems. Our competitors may also be able to independently develop products that are substantially equivalent or superior to our products or design around our patents. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. As a result, we may not be able to protect our proprietary rights adequately in the United States or abroad.

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

Table of Contents

**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 historically experienced volatility in our earnings and cash flows from operations from year to year. Although we have a \$12.0 million revolving line of credit, should we have an event of default, which includes, among other things, a failure to meet certain financial covenants and a material adverse change in the business, the bank could choose to limit or take away our ability to borrow these or any funds. Should this occur, or if the credit markets further tighten or our business declines, we may need or choose to raise additional capital to repay indebtedness, or pursue acquisitions or to expand our operations. Such additional capital may be raised through bank borrowings, or other debt or equity financings. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all, and such additional financing may result in further dilution to our stockholders.

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

- market acceptance of our products and product enhancements, and the overall level of sales of our products;
- our ability to control costs;
- the supply of key components for our products;
- our ability to increase revenue and net income;
- increased research and development expenses and sales and marketing expenses;
- our need to respond to technological advancements and our competitors' introductions of new products or technologies;
- capital improvements to new and existing facilities and enhancements to our infrastructure and systems;
- potential acquisitions of businesses and product lines;
- our relationships with customers and suppliers;

## Edgar Filing: ITERIS, INC. - Form 10-Q

- 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 the state of the financial markets, in general; 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 equity or debt 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.

**We may be unable to maintain profitability on a quarterly or annual basis.** We cannot assure you that we will be able to sustain or improve our financial performance, or that we will be able to continue to achieve profitability on a quarterly or annual basis in the future. Our ability to maintain profitability in future periods could be impacted by budgetary constraints, government and political agendas, economic instability and other items that are not in our control. 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 experience operating losses and net losses in the future, 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.

Table of Contents

**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 2001, 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 \$8.00 per share. The market price of our common stock could continue to fluctuate in the future in response to various factors, including, but not limited to:

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



- international conflicts, political unrest and acts of terrorism.

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

**Certain provisions of our charter documents may discourage a third party from acquiring us and may adversely affect the price of our common stock.** Certain provisions of our certificate of incorporation could make it difficult for a third party to acquire us, even though an acquisition might be beneficial to our stockholders. Such provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. Under the terms of our certificate of incorporation, our Board of Directors is authorized to issue, without stockholder approval, up to 2,000,000 shares of preferred stock with voting, conversion and other rights and preferences superior to those of our common stock. In August 2009, we adopted a stockholder rights plan and declared a dividend of preferred stock purchase rights to our stockholders. Generally, the stockholder rights plan provides that if a person or group acquires 15% or more of our common stock, subject to certain exceptions and under certain circumstances, the rights may be exchanged by us for common stock or the holders of the rights, other than the acquiring person or group, could acquire additional shares of our capital stock at a discount off of the then current market price. Such exchanges or exercise of rights 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.

Table of Contents

**ITEM 4. (REMOVED AND RESERVED)**

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

The following exhibits are filed herewith.

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 2.1                       | Stock Purchase Agreement dated December 23, 2010 by and among Iteris, Inc., Meridian Environmental Technology, Inc., the shareholders of MET and Kathy J. Osborne as the Shareholders Representative |
| 31.1                      | Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2                      | Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1                      | Certification of the Chief Executive Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2                      | Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

---

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.

Table of Contents

**SIGNATURES**

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

Dated: February 14, 2011

ITERIS, INC.  
(Registrant)

By /S/ ABBAS MOHADDES  
Abbas Mohaddes  
Chief Executive Officer  
(Principal Executive Officer)

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

Table of Contents

**Exhibit Index**

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 2.1                   | Purchase Agreement dated December 23, 2010 by and among Iteris, Inc., Meridian Environmental Technology, Inc., the shareholders of MET and Kathy J. Osborne as the Shareholders Representative |
| 31.1                  | Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2                  | Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1                  | Certification of the Chief Executive Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2                  | Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

---

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.