

ITERIS, INC.
Form 10-Q
February 09, 2012
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**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, 2011

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

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As of January 27, 2012, there were 34,133,124 shares of common stock outstanding.

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ITERIS, INC.

**Quarterly Report on Form 10-Q
For the Three and Nine Months Ended December 31, 2011**

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

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Iteris®, Vantage®, VantageView , VersiCam , Abacus , Vantage Vector and iPerform 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)**

| | December 31, 2011 | March 31, 2011 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------|---------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 21,519 | \$ 11,818 |
| Trade accounts receivable | 9,610 | 9,419 |
| Costs in excess of billings on uncompleted contracts | 5,434 | 4,070 |
| Inventories | 1,909 | 2,392 |
| Deferred income taxes | 2,822 | 2,927 |
| Prepaid expenses and other current assets | 618 | 392 |
| Current assets of discontinued operation | | 2,850 |
| Total current assets | 41,912 | 33,868 |
| Property and equipment, net | 2,097 | 2,461 |
| Deferred income taxes | 6,962 | 10,807 |
| Intangible assets, net | 2,602 | 1,845 |
| Goodwill | 17,318 | 16,599 |
| Other assets | 210 | 203 |
| Non-current assets of discontinued operation | | 4,822 |
| Total assets | \$ 71,101 | \$ 70,605 |
| Liabilities and stockholders equity | | |
| Current liabilities: | | |
| Trade accounts payable | \$ 3,973 | \$ 2,985 |
| Accrued payroll and related expenses | 2,787 | 3,538 |
| Accrued liabilities | 4,231 | 3,203 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 1,824 | 1,335 |
| Current portion of long-term debt | 1,092 | 2,324 |
| Current liabilities of discontinued operation | | 611 |
| Total current liabilities | 13,907 | 13,996 |
| Long-term debt | | 640 |
| Deferred rent | 792 | 1,058 |
| Unrecognized tax benefits | 406 | 587 |
| Other non-current liabilities | 642 | 1,028 |
| Total liabilities | 15,747 | 17,309 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Common stock, \$0.10 par value, 70,000 shares authorized, 34,133 and 34,364 shares issued and outstanding at December 31, 2011 and March 31, 2011, respectively | 3,413 | 3,436 |
| Additional paid-in capital | 137,865 | 137,938 |
| Accumulated deficit | (85,924) | (88,078) |
| Total stockholders equity | 55,354 | 53,296 |

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| | | | | |
|--------------------------------------------|----|--------|----|--------|
| Total liabilities and stockholders' equity | \$ | 71,101 | \$ | 70,605 |
|--------------------------------------------|----|--------|----|--------|

See accompanying notes.

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Iteris, Inc.

Unaudited Condensed Consolidated Statements of Operations

(In thousands, except per share amounts)

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|-------------------------------------------------------------------------|------------------------------------|------------|-----------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Net sales and contract revenues: | | | | |
| Net sales | \$ 6,598 | \$ 6,529 | \$ 21,234 | \$ 21,470 |
| Contract revenues | 8,283 | 5,424 | 21,932 | 16,854 |
| Total net sales and contract revenues | 14,881 | 11,953 | 43,166 | 38,324 |
| Costs of net sales and contract revenues: | | | | |
| Cost of net sales | 3,263 | 3,130 | 10,135 | 10,191 |
| Cost of contract revenues | 6,154 | 3,929 | 15,693 | 11,308 |
| Gross profit | 5,464 | 4,894 | 17,338 | 16,825 |
| Operating expenses: | | | | |
| Selling, general and administrative | 4,371 | 4,120 | 13,501 | 12,285 |
| Research and development | 868 | 657 | 2,476 | 1,831 |
| Amortization of intangible assets | 141 | 24 | 343 | 74 |
| Change in fair value of contingent acquisition consideration | (281) | | (639) | |
| Impairment of goodwill | | 7,970 | | 7,970 |
| Total operating expenses | 5,099 | 12,771 | 15,681 | 22,160 |
| Operating income (loss) | 365 | (7,877) | 1,657 | (5,335) |
| Non-operating income (expense): | | | | |
| Other income (expense), net | 3 | (7) | 4 | 13 |
| Interest expense, net | (13) | (38) | (64) | (120) |
| Income (loss) from continuing operations before income taxes | 355 | (7,922) | 1,597 | (5,442) |
| Benefit (provision) for income taxes | 263 | 836 | (715) | (187) |
| Income (loss) from continuing operations | 618 | (7,086) | 882 | (5,629) |
| Gain on sale of discontinued operation, net of tax | 129 | | 1,244 | |
| Income (loss) from discontinued operation, net of tax | | 59 | 28 | (59) |
| Net income (loss) | \$ 747 | \$ (7,027) | \$ 2,154 | \$ (5,688) |
| Income (loss) per share from continuing operations - basic and diluted | | | | |
| | \$ 0.02 | \$ (0.21) | \$ 0.03 | \$ (0.16) |
| Gain per share from sale of discontinued operation - basic and diluted | | | | |
| | \$ 0.00 | \$ 0.00 | \$ 0.04 | \$ 0.00 |
| Income (loss) per share from discontinued operation - basic and diluted | | | | |
| | \$ 0.00 | \$ 0.00 | \$ 0.00 | \$ 0.00 |
| Net income (loss) per share - basic and diluted | \$ 0.02 | \$ (0.20) | \$ 0.06 | \$ (0.17) |
| Shares used in basic per share calculations | 34,217 | 34,332 | 34,337 | 34,331 |
| Shares used in diluted per share calculations | 34,271 | 34,332 | 34,443 | 34,331 |

See accompanying notes.

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Iteris, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)

| | Nine Months Ended December 31, | |
|----------------------------------------------------------------------------------------------------------|-----------------------------------|------------|
| | 2011 | 2010 |
| Cash flows from operating activities | | |
| Net income (loss) | \$ 2,154 | \$ (5,688) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Change in deferred income taxes | 231 | 123 |
| Depreciation of property and equipment | 716 | 730 |
| Stock-based compensation | 237 | 286 |
| Impairment of goodwill | | 7,970 |
| Amortization of intangible assets | 348 | 109 |
| Change in fair value of contingent acquisition consideration | (639) | |
| Gain on sale of discontinued operation, net of tax | (1,244) | |
| Loss on disposal of property and equipment | 1 | 8 |
| Changes in operating assets and liabilities, net of effects of acquisition and sale of business segment: | | |
| Accounts receivable | (355) | 1,117 |
| Net costs and estimated earnings in excess of billings | (694) | (120) |
| Inventories | 624 | (746) |
| Prepaid expenses and other assets | 86 | 115 |
| Accounts payable and accrued expenses | 379 | 410 |
| Net cash provided by operating activities | 1,844 | 4,314 |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (295) | (298) |
| Cash paid for acquisitions | (977) | |
| Net proceeds from sale of business segment | 11,446 | |
| Net cash provided by (used in) investing activities | 10,174 | (298) |
| Cash flows from financing activities | | |
| Payments on long-term debt | (1,872) | (1,872) |
| Deferred payment for prior acquisition | (112) | (106) |
| Repurchases of common stock | (396) | |
| Proceeds from stock option exercises | 63 | 19 |
| Net cash used in financing activities | (2,317) | (1,959) |
| Increase in cash and cash equivalents | 9,701 | 2,057 |
| Cash and cash equivalents at beginning of period | 11,818 | 10,405 |
| Cash and cash equivalents at end of period | \$ 21,519 | \$ 12,462 |
| Supplemental schedule of non-cash investing and financing activities: | | |
| Liabilities incurred for acquisition | \$ 971 | \$ |

See accompanying notes.

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Iteris, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

December 31, 2011

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Iteris, Inc. (referred to collectively with our subsidiaries in these 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 and information solutions 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) solutions to customers in the United States (U.S.) and internationally. 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, 2011, the consolidated results of operations for the three and nine months ended December 31, 2011 and 2010 and the consolidated cash flows for the nine months ended December 31, 2011 and 2010. 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, 2011 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, 2011, which was filed with the SEC on June 1, 2011.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. 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 purchased

intangible assets and goodwill, the valuation of debt and equity instruments, the valuation of contingent acquisition consideration 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 when all of the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the price to the customer is fixed or determinable, and (iv) collection of the receivable is reasonably assured. These criteria are typically met at the time of product shipment, but in certain circumstances, may not be met until receipt or acceptance by the customer. Accordingly, at the date revenue is recognized, the significant obligations or 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) of fair value 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) that has stand-alone value 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.

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We account for multiple-element arrangements that consist only of software and software-related services in accordance with applicable 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 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 element and is recognized as revenue.

Contract Revenues

Contract revenues are derived primarily from long-term contracts with governmental agencies. The majority of our contract revenues are recognized using the percentage of completion method of accounting, whereby costs incurred plus a portion of estimated fees or profits are determined 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. Certain of our contract revenues are recognized as services are performed and amounts are earned, which is measured by time incurred or other contractual milestones or output measures. Contract revenues accounted for in this manner generally relate to certain cost-plus fixed fee or time-and-materials contracts for which no specific maximum contract values are stipulated.

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. We expect 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.

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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.

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 derived from revenues earned from customers located throughout North America, and to a lesser extent from customers in Europe, Asia, South America and the Middle East. 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 historically been within management's expectations.

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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.

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.

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

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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. 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 monitor the indicators for goodwill impairment testing between annual tests. Certain adverse business conditions impacting one or more reporting units would cause us to test goodwill for impairment on an interim basis. We also evaluate long-lived assets for impairment which requires impairment evaluation on long-lived assets used in operations when indicators of impairment are present. Reviews are performed to determine whether the carrying value of assets is impaired, based on a comparison 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.

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Stock-Based Compensation

We record stock-based compensation in the unaudited condensed 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 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 incurred.

Shipping and Handling Costs

Shipping and handling costs are included as cost of sales in the period during which the 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. 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 reserve is included within accrued liabilities in the accompanying unaudited condensed consolidated balance sheets.

Repair and Maintenance Costs

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We incur repair and maintenance costs in the normal course of business. Should the activity result in a permanent improvement to our property or equipment or one of our leased facilities, the cost is capitalized 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.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04), which amends Accounting Standards Codification 820, *Fair Value Measurements*. ASU 2011-04 aims to eliminate certain differences that existed between U.S. and international fair value accounting concepts, and also clarifies existing guidance in U.S. GAAP. Additionally, among other disclosures, the ASU requires certain new quantitative and qualitative disclosures regarding unobservable fair value measurements. We will be required to adopt the amendments prescribed by ASU 2011-04 for our fiscal year beginning April 1, 2012. We do not expect that the adoption of ASU 2011-04 will have a material impact on our consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 requires the presentation of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The new standard also requires presentation of adjustments for items that are reclassified from other comprehensive income to net income in the statement where the components of net income and the components of other comprehensive income are presented; however, in December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, which deferred this requirement and plans to reconsider it during the first half of calendar 2012. The amendments prescribed by ASU 2011-05 are currently scheduled to become effective on a retrospective basis for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. Early adoption is permitted. We do not expect that the adoption of ASU 2011-05 will have a material impact on our consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08, *Testing for Goodwill Impairment* (ASU 2011-08). With respect to performing their required annual test for goodwill impairment, ASU 2011-08 gives companies the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If a company concludes that this is the case, it must perform the two-step test in accordance with previously existing guidance. Otherwise, a company can skip the two-step test. ASU 2011-08 is effective for fiscal years beginning after December 15, 2011. Early adoption is permitted. We do not expect that the adoption of ASU 2011-05 will have a material impact on our consolidated financial statements.

Table of Contents**2. Supplemental Financial Information****Inventories**

The following table presents details of our inventories:

| | December 31, 2011 | March 31, 2011 |
|------------------------|----------------------|-------------------|
| | (In thousands) | |
| Materials and supplies | \$ 1,032 | \$ 1,734 |
| Work in process | 131 | 84 |
| Finished goods | 746 | 574 |
| | \$ 1,909 | \$ 2,392 |

Intangible Assets

The following table presents details of our intangible assets:

| | December 31, 2011 | | March 31, 2011 | |
|-----------------------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| | (In thousands) | | | |
| Intangible assets subject to amortization: | | | | |
| Developed technology | \$ 1,856 | \$ (874) | \$ 1,566 | \$ (719) |
| Customer contracts / relationships | 750 | (90) | 500 | (21) |
| Other | 1,110 | (150) | 550 | (31) |
| Total | \$ 3,716 | \$ (1,114) | \$ 2,616 | \$ (771) |

We do not have any intangible assets with indefinite useful lives. As of December 31, 2011, future estimated amortization expense is as follows:

**Year Ending March 31:
(In thousands)**

| | |
|-------------------|--------|
| Remainder of 2012 | \$ 161 |
| 2013 | 644 |
| 2014 | 627 |
| 2015 | 431 |
| 2016 | 360 |
| Thereafter | 379 |

\$ 2,602

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

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The following table presents activity related to the carrying value of our goodwill by reportable segment for the nine months ended December 31, 2011:

| | Roadway Sensors | Transportation Systems (In thousands) | Total |
|------------------------------------------------------|----------------------------|------------------------------------------------------|--------------|
| Balance at March 31, 2011 | \$ 8,214 | \$ 8,385 | \$ 16,599 |
| Acquisition of Berkeley Transportation Systems, Inc. | | 796 | 796 |
| Measurement period adjustments | | (77) | (77) |
| Balance at December 31, 2011 | \$ 8,214 | \$ 9,104 | \$ 17,318 |

The measurement period adjustment in the table above is due primarily to certain income tax-related adjustments pertaining to our acquisition of Meridian Environmental Technology, Inc. (MET) in January 2011.

Warranty Reserve Activity

The following table presents activity related to the warranty reserve:

| | 2011 | Nine Months Ended December 31, (In thousands) | 2010 |
|------------------------------------|-------------|--------------------------------------------------------------|-------------|
| Balance at beginning of period | \$ | 279 | \$ 297 |
| Additions charged to cost of sales | | 114 | 110 |
| Warranty claims | | (110) | (104) |
| Balance at end of period | \$ | 283 | \$ 303 |

Comprehensive Income (Loss)

Comprehensive income (loss) is equal to net income (loss) for all periods presented in the accompanying unaudited condensed consolidated statements of operations.

Earnings Per Share

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The following table sets forth the reconciliation of basic and diluted shares:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--------------------------------------------------------------------------|------------------------------------|--------|-----------------------------------|--------|
| | 2011 | 2010 | 2011 | 2010 |
| | (In thousands) | | | |
| Weighted average common shares used in basic per share calculations | 34,217 | 34,332 | 34,337 | 34,331 |
| Dilutive stock options | 54 | | 98 | |
| Dilutive restricted stock units | | | 8 | |
| Weighted average common shares used in diluted per share calculations | 34,271 | 34,332 | 34,443 | 34,331 |

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The following instruments were excluded for purposes of calculating weighted average common share equivalents in the calculation of diluted earnings per share amounts as their effect would have been anti-dilutive:

| | December 31, | | December 31, | |
|------------------------|----------------|-------|--------------|-------|
| | 2011 | 2010 | 2011 | 2010 |
| | (In thousands) | | | |
| Stock options | 2,110 | 3,173 | 2,144 | 1,690 |
| Warrants | 15 | 261 | 15 | 281 |
| Restricted stock units | | 214 | | 71 |

3. Sale of Vehicle Sensors

On July 29, 2011, we completed the sale of substantially all of our assets used in connection with our Vehicle Sensors segment to Bendix Commercial Vehicle Systems LLC ("Bendix"), a member of Knorr-Bremse Group, pursuant to an Asset Purchase Agreement (the "Agreement") signed on July 25, 2011.

Under the terms of the Agreement, upon the closing of the sale, Bendix paid us \$14 million, subject to a \$2 million holdback and adjustments based upon the working capital of the Vehicle Sensors segment at closing, and Bendix assumed certain specified obligations and liabilities of the Vehicle Sensors segment. We are entitled to additional consideration in the form of the following performance and royalty-related earn-outs: Bendix is obligated to pay us an amount in cash equal to (i) 85% of revenue associated with royalties received under our license and distribution agreements with Audiovox Electronics Corporation and Valeo Schalter and Sensoren GmbH through December 31, 2017 and (ii) 30% of the amount, if any, by which the amount of revenue generated from the sale of our lane departure warning systems exceeds Bendix's projection for such revenue for the two years following closing, each subject to certain reductions and limitations set forth in the Agreement.

Upon the closing of the sale and resolution of working capital adjustments (as described above), we recorded aggregate proceeds received of approximately \$12.0 million. Legal and other professional fees of approximately \$0.4 million that were directly related to the sale transaction were offset against the proceeds to calculate net proceeds from the sale of approximately \$11.6 million.

The following table summarizes the assets and liabilities of the Vehicle Sensors segment as of the sale date (in thousands):

| | | |
|-----------------------------|----|-------|
| Cash | \$ | 105 |
| Accounts receivable | | 1,850 |
| Inventories | | 1,147 |
| Other current assets | | 31 |
| Property and equipment, net | | 133 |
| Goodwill | | 4,671 |
| Total assets | | 7,937 |
| Current liabilities | | (691) |
| Net assets | \$ | 7,246 |

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In comparing the above net assets to the net proceeds received, we recorded a gain on the sale of \$4.3 million, or \$1.1 million after tax, in the accompanying unaudited condensed consolidated statements of operations for the nine months ended December 31, 2011. The effective tax rate applicable to the gain was impacted by goodwill of \$4.7 million for which there is no corresponding tax basis. During the three and nine months ended December 31, 2011, we also recorded a gain on the sale of approximately \$189,000, or \$129,000 after tax, related to certain performance and royalty-related earn-outs (as described above) that were achieved through December 31, 2011.

In accordance with applicable accounting guidance, we determined that the Vehicle Sensors segment, which constituted one of our operating segments, qualifies as a discontinued operation. The applicable financial results of the Vehicle Sensors segment have been reported as a discontinued operation in the unaudited condensed consolidated statements of operations for all periods presented. For the three months ended December 31, 2011 and 2010, Vehicle Sensors net sales classified as part of discontinued operation was \$0 and \$2.1 million, respectively. For the nine months ended December 31, 2011 and 2010, Vehicle Sensors net sales classified as part of discontinued operation were \$3.2 million and \$5.5 million, respectively. We have elected not to allocate any interest expense to discontinued operation. Additionally, the applicable net assets of the Vehicle Sensors segment are separately presented as assets and liabilities of discontinued operation in the accompanying unaudited condensed consolidated balance sheet as of March 31, 2011.

We have entered into a short-term transitional services agreement with Bendix that is scheduled to terminate at the end of February 2012, pursuant to which we provide them certain ongoing logistical and administrative support services. Bendix pays us a fixed monthly amount for such support services, and also pays us an hourly amount for providing certain development-related services during the transition period.

Table of Contents**4. Acquisition**

In November 2011, we acquired all of the outstanding capital stock of Berkeley Transportation Systems, Inc. (*BTS*). *BTS* was a privately-held company based in Berkeley, California which specializes in transportation performance measurement. *BTS* Performance Measurement System leverages its real-time data collection, diagnostic, fusion and warehousing platform to aggregate and compute performance measures. This information is used to analyze how a transportation system is performing based on pre-determined measures of effectiveness such as stops, delays, and travel time. Our primary reasons for the acquisition were to add key technologies to complement our iPerform solution and strengthen our performance measurement and management initiative as a whole.

Our consolidated financial statements for the three and nine months ended December 31, 2011 include the results of operations of *BTS* commencing as of the acquisition date. On or shortly after the acquisition date, we paid a total of approximately \$840,000 in cash to *BTS*. Additionally, we are also scheduled to pay (i) up to \$250,000 at the 24-month anniversary of the closing of the acquisition, pursuant to a holdback provision, (ii) up to \$500,000 at the 36-month anniversary of the closing of the acquisition, pursuant to a deferred payment provision, and (iii) up to \$750,000 pursuant to an earn-out provision based on revenue and operating income achieved from *BTS* operations during the 18 months ending June 30, 2013. Our potential obligation pertaining to the various contingent consideration payments ranges from \$0 to \$1.5 million. Acquisition-related costs were not significant and are included in selling, general and administrative expenses in the accompanying unaudited condensed consolidated statements of operations for the three and nine months ended December 31, 2011.

Acquisition Accounting

We have accounted for this acquisition as a business combination in accordance with applicable accounting guidance. We measured the fair value of the consideration transferred (including contingent consideration) to determine the purchase price of the acquisition. We allocated the fair value of consideration transferred to tangible assets acquired, liabilities assumed and identifiable intangible assets acquired based on their estimated fair values at the acquisition date.

The acquisition is recorded as follows (in thousands):

| | |
|--------------------------------------------------|---------|
| Fair value of consideration transferred: | |
| Cash paid on or shortly after acquisition date | \$ 840 |
| Estimated fair value of contingent consideration | 971 |
| Total | 1,811 |
| Allocation: | |
| Accounts receivable | (164) |
| Other tangible assets | (375) |
| Purchased intangible assets | (1,100) |
| Liabilities | 624 |
| Goodwill | \$ 796 |

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The excess of the fair value of the business over the aggregate fair values of identifiable assets acquired and liabilities assumed was recorded as goodwill. The primary factor that resulted in the recognition of goodwill was the acquisition of BTS assembled workforce, which is not a separately identifiable intangible asset. The goodwill is not expected to be deductible for income tax purposes.

Table of Contents*Purchased Intangible Assets*

The following table presents details of the intangible assets acquired:

| | Estimated Useful Life (In years) | Amount (In thousands) |
|------------------------------------|----------------------------------------|--------------------------|
| Backlog | 3 | \$ 330 |
| Developed technology | 6 | 290 |
| Customer contracts / relationships | 6 | 250 |
| Other purchased intangible assets | 5 - 7 | 230 |
| | | \$ 1,100 |

Supplemental Pro Forma Data

The unaudited pro forma data below presents selected details of our results of operations as if the acquisition of BTS had occurred on April 1, 2010. The following data includes the amortization of purchased intangible assets. This pro forma data is presented for informational purposes only and does not purport to be indicative of the results of future operations or the results that would have occurred had the acquisition taken place on April 1, 2010.

| | Nine Months Ended December 31, | |
|-----------------------------------------------------------|---------------------------------------|------------|
| | 2011 | 2010 |
| | (In thousands, except per share data) | |
| Pro forma net sales and contract revenues | \$ 44,313 | \$ 39,601 |
| Pro forma net income (loss) | \$ 2,025 | \$ (6,031) |
| Pro forma net income (loss) per share - basic and diluted | \$ 0.06 | \$ (0.18) |

5. 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.

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The liability for the estimated fair value of the contingent consideration in connection with our acquisitions of MET and BTS was determined using Level 3 inputs based on probabilistic calculations whereby we assigned estimated probabilities to achieving the earn-out targets and then discounted the total contingent consideration to net present value. The following table reconciles this liability measured at fair value on a recurring basis for the nine months ended December 31, 2011 (in thousands):

| | | |
|------------------------------------------------------------------------|----|-------|
| Balance at March 31, 2011 | \$ | 2,528 |
| Fair value of BTS contingent consideration assumed at acquisition date | | 971 |
| Change in fair value included in net income | | (639) |
| Balance at December 31, 2011 | \$ | 2,860 |

The change in the estimated fair value of this liability during the nine months ended December 31, 2011 resulted primarily from revisions to our estimates regarding both the probability of achieving certain earn-out targets and the amounts of certain future deferred payments.

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The current portions of the liability at December 31, 2011 and March 31, 2011 were \$2.2 million and \$1.5 million, respectively, and were included within accrued liabilities in the accompanying unaudited condensed consolidated balance sheets. The remaining non-current portions of the liability are included within non-current liabilities in the accompanying unaudited condensed consolidated balance sheets. The change in the estimated fair value of the liability for the three and nine months ended December 31, 2011 is included as part of operating expenses in the accompanying unaudited condensed consolidated statements of operations.

Other than the above, we did not have any material financial assets or liabilities measured at fair value on a recurring basis using Level 3 inputs as of December 31, 2011 or March 31, 2011.

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 at fair value at December 31, 2010 as a result of an impairment charge, no non-financial assets were measured at fair value during the three and nine months ended December 31, 2011 and 2010.

6. Revolving Line of Credit and Long-Term Debt

Revolving Line of Credit

We currently maintain a credit facility that provides for (i) a revolving line of credit, expiring on October 1, 2012, with borrowings of up to \$12.0 million and (ii) a \$7.5 million term note (discussed below). 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, 2011) 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, 2011, no amounts were borrowed 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.

Long-Term Debt Bank Term Note

As of December 31, 2011, we had outstanding borrowings of approximately \$1.1 million under the term note with our bank referenced above, which expires on May 1, 2013. Principal payments under this term note are required to be repaid in monthly installments of \$152,000. 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 each of November 1, 2011, 2010 and 2009. 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. We currently expect the remaining outstanding balance of this term note will be repaid in full by August 2012.

7. **Income Taxes**

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

| | | | | | | | | |
|--------------------------------------|------------|---------|----|---------|----|-------|----|-------|
| | [REDACTED] | | | | | | | |
| Benefit (provision) for income taxes | \$ | 263 | \$ | 836 | \$ | (715) | \$ | (187) |
| Effective tax rate | | (74.1)% | | (10.6)% | | 44.8% | | 3.4% |

Our effective tax rates in the three and nine months ended December 31, 2011 were favorably impacted by benefits from certain research and development credits that we claimed for the current and prior fiscal years, as well as from the recognition of approximately \$271,000 of previously unrecognized tax benefits during the current quarter due to the expiration of certain federal and state statutes in various jurisdictions. Additionally, during the nine months ended December 31, 2011, the above favorable impacts partially offset the unfavorable impact that originated in the prior quarter from the recording of a valuation allowance against certain of our state net operating losses (NOLs). As a result of newly issued guidance from a state tax authority concerning the applicable carryforward period for NOLs, we recorded a valuation allowance of \$734,000 against certain of our state NOLs. This resulted in additional income tax expense, net of a federal benefit, of \$484,000 for the nine months ended December 31, 2011.

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As of March 31, 2011 (our prior fiscal year-end), we did not have any valuation allowance recorded against our deferred tax assets. A valuation allowance is required when it is more likely than not that all or a portion of a deferred tax asset will not be realized.

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 \$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 during the three months ended December 31, 2010 of previously unrecognized tax benefits 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.

8. 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.

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. In September 2011, accrued interest of \$16,000, along with \$14,000 of the principal balance of the note, were paid off through the rendering of agreed-upon bona fide services by MAXxess to Iteris. As of December 31 2011, \$260,000 in principal on the note remained outstanding and payable to Iteris. This balance continues to be fully reserved.

9. Employee Benefit Plans

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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, 2011, there were 663,000 shares of common stock available for grant under the 2007 Plan.

Table of Contents**Stock Options**

A summary of activity with respect to our stock options for the nine months ended December 31, 2011 is as follows:

| | Number of Shares (In thousands) | Weighted Average Exercise Price per Share |
|------------------------------------------|---------------------------------------|-------------------------------------------------------|
| Options outstanding at March 31, 2011 | 3,111 | \$ 1.59 |
| Granted | 70 | 1.23 |
| Exercised | (53) | 1.19 |
| Expired | (833) | 1.30 |
| Forfeited | (24) | 1.58 |
| Options outstanding at December 31, 2011 | 2,271 | \$ 1.69 |

Restricted Stock Units

A summary of activity with respect to our RSUs, which entitle the holder to receive one share of our common stock for each RSU upon vesting, for the nine months ended December 31, 2011 is as follows:

| | Number of Shares (In thousands) |
|---------------------------------------------------------|---------------------------------------|
| Restricted stock units outstanding at March 31, 2011 | 214 |
| Restricted stock units vested | (51) |
| Restricted stock units forfeited | (19) |
| Restricted stock units outstanding at December 31, 2011 | 144 |

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 December 31, | | Nine Months Ended December 31, | |
|---------------------------|------------------------------------|------|-----------------------------------|------|
| | 2011 | 2010 | 2011 | 2010 |
| | (In thousands) | | | |
| Cost of net sales | \$ 4 | \$ 3 | \$ 10 | \$ 8 |
| Cost of contract revenues | 5 | 9 | 21 | 26 |

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| | | | | |
|-------------------------------------------------------|-------|--------|--------|--------|
| Selling, general and administrative expense | 46 | 76 | 180 | 221 |
| Research and development expense | 7 | 8 | 20 | 16 |
| Income (loss) from discontinued operation, net of tax | | 4 | 6 | 15 |
| | \$ 62 | \$ 100 | \$ 237 | \$ 286 |

At December 31, 2011, there was approximately \$368,000 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 1.9 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, 2011 has been estimated using the following weighted average assumptions:

| | |
|--------------------------------------------------|---------|
| Expected life - years | 7 |
| Risk-free interest rate | 1.8% |
| Expected volatility of common stock | 52% |
| Dividend yield | |
| Weighted-average grant date fair value per share | \$ 0.67 |

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10. Stock Repurchase Program

In August 2011, our board of directors approved a stock repurchase program covering up to \$3 million of our common stock over 12 months. Under the program, we may repurchase shares from time to time in open-market and privately negotiated transactions and block trades and pursuant to a 10b5-1 trading plan during our closed trading windows. There is no guarantee as to the exact number of shares that will be repurchased. We may modify, terminate or extend the repurchase program at any time without prior notice. From inception of this program through December 31, 2011 we repurchased approximately 334,000 shares of our common stock at a weighted average price per share of \$1.19. All repurchased shares have been retired and resumed their status as authorized and unissued shares of our common stock.

11. Business Segment Information

As a result of the sale of substantially all of the assets used in connection with our Vehicle Sensors segment to Bendix in July 2011 (see Note 3), along with a reevaluation and reorganization of our operating segments in the first quarter of our fiscal year ending March 31, 2012, we now operate in two reportable segments: Roadway 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, as well as our Abacus products.

The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. This segment includes the operations of MET, which specializes in 511 advanced traveler information systems and offers Maintenance Decision Support System management tools that allow users to create solutions to meet roadway maintenance decision needs. Also included in this segment are the operations of BTS, which was acquired in November 2011 and specializes in transportation performance measurement (see Note 4).

The accounting policies of our reportable segments are the same as those described in the summary of significant accounting policies (Note 1). Certain corporate expenses, including interest and amortization of intangible assets, are not allocated to the segments. Unallocated corporate expenses in the current fiscal year also include costs related to the sale of our Vehicle Sensors segment and certain other corporate initiatives, as well as costs related to our recently announced iPerform information management solution. The reportable segments are each managed separately because they manufacture and distribute distinct products or provide services with different processes. All reported segment revenues are derived from external customers.

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The following table sets forth selected unaudited consolidated financial information for our reportable segments for the three and nine months ended December 31, 2011 and 2010:

| | Roadway Sensors | Transportation Systems (In thousands) | Total |
|---------------------------------------------|--------------------|---------------------------------------------|-----------|
| Three Months Ended December 31, 2011 | | | |
| Product revenue | \$ 6,598 | \$ | \$ 6,598 |
| Service and other revenue | | 8,283 | 8,283 |
| Segment income | 373 | 249 | 622 |
| Three Months Ended December 31, 2010 | | | |
| Product revenue | \$ 6,529 | \$ | \$ 6,529 |
| Service and other revenue | | 5,424 | 5,424 |
| Impairment of goodwill | | 7,970 | 7,970 |
| Segment income (loss) | 797 | (8,354) | (7,557) |
| Nine Months Ended December 31, 2011 | | | |
| Product revenue | \$ 21,234 | \$ | \$ 21,234 |
| Service and other revenue | | 21,932 | 21,932 |
| Segment income | 2,533 | 516 | 3,049 |
| Nine Months Ended December 31, 2010 | | | |
| Product revenue | \$ 21,470 | \$ | \$ 21,470 |
| Service and other revenue | | 16,854 | 16,854 |
| Impairment of goodwill | | 7,970 | 7,970 |
| Segment income (loss) | 3,377 | (7,876) | (4,499) |

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--------------------------------------------------------------|------------------------------------|------------|-----------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Segment income (loss): | | | | |
| Total income (loss) from reportable segments | \$ 622 | \$ (7,557) | \$ 3,049 | \$ (4,499) |
| Unallocated amounts: | | | | |
| Corporate and other expenses | (397) | (296) | (1,688) | (762) |
| Amortization of intangible assets | (141) | (24) | (343) | (74) |
| Change in fair value of contingent acquisition consideration | 281 | | 639 | |
| Other income (expense), net | 3 | (7) | 4 | 13 |
| Interest expense, net | (13) | (38) | (64) | (120) |
| Income (loss) from continuing operations before income taxes | \$ 355 | \$ (7,922) | \$ 1,597 | \$ (5,442) |

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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 and information solutions 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 solutions to customers in the U.S. and internationally.

Acquisitions. In November 2011, we acquired all of the outstanding capital stock of Berkeley Transportation Systems, Inc. (BTS), a privately-held company based in Berkeley, California which specializes in transportation performance measurement. On or shortly after the acquisition date, we paid a total of approximately \$840,000. Additionally, we are scheduled to pay up to a total of \$1.5 million within 36 months after the acquisition date pursuant to holdback, deferred payment and earn-out provisions. Refer to Note 4 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report for additional discussion on this acquisition.

In January 2011, we acquired all of the capital stock of Meridian Environmental Technology, Inc. (MET) for an initial cash payment of approximately \$1.6 million. MET specializes in 511 advanced traveler information systems and offers 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.

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

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Divestiture. On July 29, 2011, we completed the sale of substantially all of our assets used in connection with our Vehicle Sensors segment to Bendix Commercial Vehicle Systems LLC (Bendix), a member of Knorr-Bremse Group, pursuant to an Asset Purchase Agreement signed on July 25, 2011. Upon closing, Bendix paid us \$14 million, subject to a \$2 million holdback and adjustments based upon the working capital of the Vehicle Sensors segment at closing, and Bendix assumed certain specified obligations and liabilities of the Vehicle Sensors segment. We are entitled to additional consideration in the form of certain performance and royalty-related earn-outs. As a result of the sale of substantially all of the assets of this segment, we no longer operate in the Vehicle Sensors segment. Refer to Note 3 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report for additional discussion on this transaction.

Business Segments. Subsequent to the sale of substantially all of the assets of our Vehicle Sensors segment, we now operate in two reportable segments: Roadway Sensors and Transportation Systems.

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. Our VantageView software supplements our Vantage video detection systems by providing an integrated platform to manage and see video detection assets remotely over a network connection. In October 2011, we announced the introduction of Vantage Vector vehicle detection solution, which, through sensor fusion, enhances our video detection capabilities with radar sensor technology.

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- 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.

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. This segment also includes the activities of MET, which we acquired in January 2011, and which specializes in 511 advanced traveler information systems as well as Maintenance Decision Support System (MDSS) management tools that allow users to create solutions to meet roadway maintenance decision needs. The operations of BTS, which we acquired in November 2011, are also included in this segment. BTS specializes in transportation performance measurement and its Performance Measurement System leverages its real-time data collection, diagnostic, fusion and warehousing platform to aggregate and compute performance measures.

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. Congress is currently working on such a bill and has recently agreed to extend the current funding levels under the previously expired Federal Highway Bill through March 2012. Continued delays in the enactment of such a new Federal Highway Bill, and until such time as a bill becomes law, will prolong the uncertainty regarding the allotment of transportation funds in federal, state and local budgets. We believe that prolonged uncertainty has adversely impacted, and may continue to adversely impact, our net sales and contract revenues and our overall financial performance in future periods.

Critical Accounting Policies and Estimates

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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, the valuation of contingent acquisition consideration, 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, intangible assets, goodwill, warranty, income taxes, and stock-based compensation. These policies are described in further detail in our Annual Report on Form 10-K for the fiscal year ended March 31, 2011 (fiscal 2011). There have been no significant changes in our critical accounting policies and estimates during the three and nine months ended December 31, 2011 as compared to what was previously disclosed in our Annual Report on Form 10-K for fiscal 2011.

Table of Contents**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.

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 December 31, | | Nine Months Ended December 31, | |
|--------------------------------------------------------------|------------------------------------|---------|-----------------------------------|---------|
| | 2011 | 2010 | 2011 | 2010 |
| Net sales and contract revenues: | | | | |
| Net sales | 44.3% | 54.6% | 49.2% | 56.0% |
| Contract revenues | 55.7 | 45.4 | 50.8 | 44.0 |
| 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 | 21.9 | 26.2 | 23.5 | 26.6 |
| Cost of contract revenues | 41.4 | 32.9 | 36.4 | 29.5 |
| Gross profit | 36.7 | 40.9 | 40.2 | 43.9 |
| Operating expenses: | | | | |
| Selling, general and administrative | 29.4 | 34.5 | 31.3 | 32.1 |
| Research and development | 5.8 | 5.5 | 5.7 | 4.8 |
| Amortization of intangible assets | 0.9 | 0.2 | 0.8 | 0.2 |
| Change in fair value of contingent acquisition consideration | (1.9) | | (1.5) | |
| Impairment of goodwill | | 66.7 | | 20.8 |
| Total operating expenses | 34.3 | 106.8 | 36.3 | 57.8 |
| Operating income (loss) | 2.5 | (65.9) | 3.8 | (13.9) |
| Non-operating income (expense): | | | | |
| Other income (expense), net | 0.0 | (0.1) | 0.0 | 0.0 |
| Interest expense, net | (0.1) | (0.3) | (0.1) | (0.3) |
| Income (loss) from continuing operations before income taxes | 2.4 | (66.3) | 3.7 | (14.2) |
| Benefit (provision) for income taxes | 1.8 | 7.0 | (1.7) | (0.5) |
| Income (loss) from continuing operations | 4.2 | (59.3) | 2.0 | (14.7) |
| Gain on sale of discontinued operation, net of tax | 0.9 | | 2.9 | |
| Income (loss) from discontinued operation, net of tax | | 0.5 | 0.1 | (0.2) |
| Net income (loss) | 5.0% | (58.8)% | 5.0% | (14.8)% |

Analysis of Quarterly Results of Operations

Net Sales and Contract Revenues. Net sales are comprised of sales from our Roadway Sensors segment. Contract revenues consist of revenues from our Transportation Systems segment.

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The following tables present details of our net sales and contract revenues for the three and nine months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, | | Increase | % Change |
|---------------------------------------|------------------------------------|-----------|----------|-------------|
| | 2011 | 2010 | | |
| | (In thousands, except percentages) | | | |
| Net sales | \$ 6,598 | \$ 6,529 | \$ 69 | 1.1% |
| Contract revenues | 8,283 | 5,424 | 2,859 | 52.7 |
| Total net sales and contract revenues | \$ 14,881 | \$ 11,953 | \$ 2,928 | 24.5% |

| | Nine Months Ended December 31, | | Increase (Decrease) | % Change |
|---------------------------------------|------------------------------------|-----------|------------------------|-------------|
| | 2011 | 2010 | | |
| | (In thousands, except percentages) | | | |
| Net sales | \$ 21,234 | \$ 21,470 | \$ (236) | (1.1)% |
| Contract revenues | 21,932 | 16,854 | 5,078 | 30.1 |
| Total net sales and contract revenues | \$ 43,166 | \$ 38,324 | \$ 4,842 | 12.6% |

We have historically had a diverse customer base. For the nine months ended December 31, 2011 and 2010, no individual customer represented greater than 10% of our total net sales and contract revenues.

Net Sales

Net sales for the nine months ended December 31, 2011 were marginally lower than the corresponding period in the prior year due primarily to certain international customer orders in the prior year which did not recur in the current year.

Contract Revenues

Our 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. Contract revenues for the three and nine months ended December 31, 2011 increased compared to the corresponding periods in the prior year due in part to several significant project wins in the last two quarters, one of which contains significant sub-consulting content. Additionally, we recognized \$1.7 million and \$3.7 million of total revenues in the three and nine months ended December 31, 2011, respectively, derived from our acquisitions of MET and BTS.

Going forward, we plan to continue to pursue larger 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. We also intend to continue to expand our foreign operations by pursuing additional international opportunities in the Middle East and other regions. Among other factors, we believe the ability of our Transportation Systems segment to grow and successfully win and service new contracts will be highly dependent upon our continued success in recruiting and retaining qualified personnel, as well as upon government funding initiatives in the markets we serve.

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Gross Profit. The following tables present details of our gross profit for the three and nine months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, | | Increase | % Change |
|--------------------------------------------------------------------|------------------------------------|----------|----------|-------------|
| | 2011 | 2010 | | |
| | (In thousands, except percentages) | | | |
| Total gross profit | \$ 5,464 | \$ 4,894 | \$ 570 | 11.6% |
| Total gross profit as a % of total net sales and contract revenues | 36.7% | 40.9% | | |
| Gross profit as a % of net sales | 50.5% | 52.1% | | |
| Gross profit as a % of contract revenues | 25.7% | 27.6% | | |

| | Nine Months Ended December 31, | | Increase | % Change |
|--------------------------------------------------------------------|------------------------------------|-----------|----------|-------------|
| | 2011 | 2010 | | |
| | (In thousands, except percentages) | | | |
| Total gross profit | \$ 17,338 | \$ 16,825 | \$ 513 | 3.0% |
| Total gross profit as a % of total net sales and contract revenues | 40.2% | 43.9% | | |
| Gross profit as a % of net sales | 52.3% | 52.5% | | |
| Gross profit as a % of contract revenues | 28.4% | 32.9% | | |

Our total gross profit as a percentage of total net sales and contract revenues decreased for the three and nine months ended December 31, 2011 as compared to the corresponding periods in the prior year primarily as a result of our product and service mix. Our net sales (derived from our Roadway Sensors segment) represented approximately 44% and 49% of our total net sales and contract revenues for the three and nine months ended December 31, 2011, respectively, as compared to 55% and 56%, respectively, for the corresponding prior year periods. Our net sales generally carry higher margins than our contract revenues derived primarily from our consulting services.

Gross profit as a percent of net sales (gross margin) decreased for the three months ended December 31, 2011 as compared to the corresponding period in the prior year primarily due to higher materials costs in the current quarter, along with higher reserve for excess and obsolete inventories. Our gross margin 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 shifts of engineering resources from development activities to sustaining activities, which we record as cost of goods sold.

We recognize the majority of our 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 nine months ended December 31, 2011 was lower than the comparable prior year period primarily due to lower margins stemming from seasonality due to the decrease in revenues from certain of our MDSS and weather forecasting services in the spring and summer time periods. Also, the overall mix of contract revenues in the current year periods, particularly the current quarter, contained a significant proportion of lower-margin sub-consulting content. We expect to experience variability in our Transportation Systems segment in future periods due to our contract mix and related sub-consulting content, as well as factors such as paid holidays and our ability to efficiently utilize our workforce, which will cause fluctuations in our margins from contract revenues from period to period.

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Selling, General and Administrative Expense. The following tables present selling, general and administrative expense for the three and nine months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, 2011 | | Three Months Ended December 31, 2010 | | Increase | % Change |
|----------------------------------------|-----------------------------------------|-----------------------------------------------|-----------------------------------------|-----------------------------------------------|----------|-------------|
| | Amount | % of Net Sales and Contract Revenues | Amount | % of Net Sales and Contract Revenues | | |
| | (In thousands, except percentages) | | | | | |
| Salary and personnel-related | \$ 2,922 | 19.6% | \$ 2,820 | 23.6% | \$ 102 | 3.6% |
| Facilities, insurance and supplies | 497 | 3.3 | 493 | 4.1 | 4 | 0.8 |
| Travel and conferences | 459 | 3.1 | 342 | 2.9 | 117 | 34.2 |
| Professional and outside services | 325 | 2.2 | 311 | 2.6 | 14 | 4.5 |
| Other | 168 | 1.1 | 154 | 1.3 | 14 | 9.1 |
| Selling, general and administrative | \$ 4,371 | 29.4% | \$ 4,120 | 34.5% | \$ 251 | 6.1% |

| | Nine Months Ended December 31, 2011 | | Nine Months Ended December 31, 2010 | | Increase (Decrease) | % Change |
|----------------------------------------|----------------------------------------|-----------------------------------------------|----------------------------------------|-----------------------------------------------|------------------------|-------------|
| | Amount | % of Net Sales and Contract Revenues | Amount | % of Net Sales and Contract Revenues | | |
| | (In thousands, except percentages) | | | | | |
| Salary and personnel-related | \$ 9,330 | 21.6% | \$ 8,579 | 22.4% | \$ 751 | 8.8% |
| Facilities, insurance and supplies | 1,419 | 3.3 | 1,616 | 4.2 | (197) | (12.2) |
| Travel and conferences | 1,247 | 2.9 | 1,010 | 2.6 | 237 | 23.5 |
| Professional and outside services | 1,225 | 2.8 | 925 | 2.4 | 300 | 32.4 |
| Other | 280 | 0.6 | 155 | 0.4 | 125 | 80.6 |
| Selling, general and administrative | \$ 13,501 | 31.3% | \$ 12,285 | 32.1% | \$ 1,216 | 9.9% |

The overall increases in selling, general and administrative expense for the three and nine months ended December 31, 2011 as compared to the corresponding periods in the prior year were primarily due to (i) higher salary, travel and headcount-related expenses as we have added certain key sales and marketing personnel and added personnel as a result of the MET and BTS acquisitions and (ii) legal and professional services related to the sale of our Vehicle Sensors segment and certain other corporate initiatives. Additionally, in the nine months ended September 30, 2010, we realized approximately \$250,000 in reversals of previously recorded bad debt expense (included in the Other category in the table above) primarily 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.

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Research and Development Expense. The following tables present research and development expense for the three and nine months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, 2011 | | Three Months Ended December 31, 2010 | | Increase (Decrease) | % Change |
|--------------------------------------|-----------------------------------------|-----------------------------------------------|-----------------------------------------|-----------------------------------------------|------------------------|-------------|
| | Amount | % of Net Sales and Contract Revenues | Amount | % of Net Sales and Contract Revenues | | |
| | (In thousands, except percentages) | | | | | |
| Salary and personnel-related | \$ 610 | 4.1% | \$ 478 | 4.0% | \$ 132 | 27.6% |
| Facilities, development and supplies | 224 | 1.5 | 116 | 1.0 | 108 | 92.8 |
| Other | 34 | 0.2 | 63 | 0.5 | (29) | (45.8) |
| Research and development | \$ 868 | 5.8% | \$ 657 | 5.5% | \$ 211 | 32.1% |

| | Nine Months Ended December 31, 2011 | | Nine Months Ended December 31, 2010 | | Increase | % Change |
|--------------------------------------|----------------------------------------|-----------------------------------------------|----------------------------------------|-----------------------------------------------|----------|-------------|
| | Amount | % of Net Sales and Contract Revenues | Amount | % of Net Sales and Contract Revenues | | |
| | (In thousands, except percentages) | | | | | |
| Salary and personnel-related | \$ 1,732 | 4.0% | \$ 1,282 | 3.3% | \$ 450 | 35.1% |
| Facilities, development and supplies | 594 | 1.4 | 415 | 1.1 | 179 | 43.1 |
| Other | 150 | 0.3 | 134 | 0.3 | 16 | 12.2 |
| Research and development | \$ 2,476 | 5.7% | \$ 1,831 | 4.8% | \$ 645 | 35.2% |

Research and development expenses for the three and nine months ended December 31, 2011 were higher than the corresponding periods in the prior year primarily due to (i) the allocation of additional resources to various development projects in our Roadway Sensors segment, including our recently announced Vantage Vector vehicle detection sensor, (ii) development costs related to our recently announced iPerform information management solution and (iii) the addition of headcount and other expenses in the current year period related to MET and BTS.

Fair Value of Contingent Acquisition Consideration. During the three and nine months ended December 31, 2011, we recorded net decreases of \$281,000 and \$639,000, respectively, to the liability for the estimated fair value of the contingent consideration related to our acquisitions of MET and BTS. The decreases resulted primarily from revisions to our estimates regarding both the probability of achieving certain earn-out targets and the amounts of certain future deferred payments. In future periods, the estimated fair value of this liability may increase or decrease as we reevaluate our estimates based on the relevant facts and circumstances and the related financial performance attributable to MET and BTS.

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Income Taxes. The following tables present our provision for income taxes for the three and nine months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, | | | Decrease | % |
|--------------------------|------------------------------------|---------|--|----------|--------|
| | 2011 | 2010 | | | |
| | (In thousands, except percentages) | | | | Change |
| Benefit for income taxes | \$ 263 | \$ 836 | | \$ (573) | (69)% |
| Effective tax rate | (74.1)% | (10.6)% | | | |

| | Nine Months Ended December 31, | | | Increase | % |
|----------------------------|------------------------------------|----------|--|----------|--------|
| | 2011 | 2010 | | | |
| | (In thousands, except percentages) | | | | Change |
| Provision for income taxes | \$ (715) | \$ (187) | | \$ (528) | 282% |
| Effective tax rate | 44.8% | 3.4% | | | |

Our effective tax rates in the three and nine months ended December 31, 2011 were favorably impacted by benefits from certain research and development credits that we claimed for the current and prior fiscal years, as well as from the recognition of approximately \$271,000 of previously unrecognized tax benefits during the current quarter due to the expiration of certain federal and state statutes in various jurisdictions. Additionally, during the nine months ended December 31, 2011, the above favorable impacts partially offset the unfavorable impact that originated in the prior quarter from the recording of a valuation allowance against certain of our state net operating losses (NOLs). As a result of newly issued guidance from a state tax authority concerning the applicable carryforward period for NOLs, we recorded a valuation allowance of \$734,000 against certain of our state NOLs. This resulted in additional income tax expense, net of a federal benefit, of \$484,000 for the nine months ended December 31, 2011.

As of March 31, 2011 (our prior fiscal year-end), we did not have any valuation allowance recorded against our deferred tax assets. A valuation allowance is required when it is more likely than not that all or a portion of a deferred tax asset will not be realized.

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 \$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 during the three months ended December 31, 2010 of previously unrecognized tax benefits 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.

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, 2011, we had \$27.8 million in working capital, which included no borrowings on our \$12.0 million line of credit and \$21.5 million in cash and cash equivalents. This compares to working capital of \$19.9 million at March 31, 2011, which included no borrowings on our line of credit and \$11.8 million in cash and cash equivalents.

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The following table summarizes our cash flows for the nine months ended December 31, 2011 and 2010:

| | Nine Months Ended December 31, | |
|----------------------------------------|-----------------------------------|----------|
| | 2011 | 2010 |
| | (In thousands) | |
| Net cash provided by (used in): | | |
| Operating activities | \$ 1,844 | \$ 4,314 |
| Investing activities | 10,174 | (298) |
| Financing activities | (2,317) | (1,959) |

Operating Activities. Cash provided by our operations for the nine months ended December 31, 2011 was primarily the result of our net income of approximately \$2.2 million, along with approximately \$1.5 million in non-cash items for depreciation, amortization, stock-based compensation expense and adjustments to deferred tax assets. This was partially offset by approximately \$1.9 million in non-cash income that was comprised of a \$1.2 million net gain on the sale of our Vehicle Sensors segment and \$639,000 due to the change in fair value of contingent consideration related to the MET and BTS acquisitions.

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.

Investing Activities. Cash provided by our investing activities during the nine months ended December 31, 2011 consisted of \$11.5 million in net proceeds from the sale of substantially all of the assets of our Vehicle Sensors segment, partially offset by (i) \$840,000 used for the acquisition of BTS, (ii) \$295,000 for purchases of property and equipment and (iii) a \$137,000 payment related to the MET acquisition. Cash used in our investing activities during the nine months ended December 31, 2010 consisted of \$298,000 for purchases of property and equipment.

Financing Activities. Net cash used in financing activities during the nine months ended December 31, 2011 was primarily the result of (i) \$1.9 million in payments on our long-term debt, (ii) \$396,000 in cash used to repurchase shares of our common stock and (iii) \$112,000 representing the final payment for the acquisition of certain assets of Hamilton Signal. Net cash used in financing activities during the nine months ended December 31, 2010 was primarily the result of \$1.9 million in payments on our long-term debt and \$106,000 representing the first anniversary payment for the acquisition of certain assets of Hamilton Signal.

Borrowings

In October 2008, we entered into a \$19.5 million credit facility with California Bank & Trust (the Bank), which provided for a two-year revolving line of credit with borrowings of up to \$12.0 million and a \$7.5 million 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, 2011) 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

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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, 2011, 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, 2011, we had outstanding borrowings of approximately \$1.1 million under our bank term note, which expires on May 1, 2013. Principal payments under this term note are required to be repaid in monthly installments of \$152,000. 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 each of November 1, 2011, 2010 and 2009. 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. We currently expect the remaining outstanding balance will be paid off in full by August 2012.

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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, 2011.

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. We have also recently experienced, and expect to continue to experience seasonality with respect to revenues from our MDSS and related weather forecasting services within our Transportation Systems segment, due to the decrease in revenues generated for such services during the spring and summer time periods when weather conditions are generally better.

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.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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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.

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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 8 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report, is incorporated herein by reference. For additional discussion of risks associated with legal proceedings, see "Risk Factors" below.

ITEM 1A. RISK FACTORS

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

The economic slowdown has reduced and delayed government funding for transportation infrastructure projects and initiatives, decreased availability of financial capital for our customers and adversely impacted real estate development, all of which have 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 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 decline in the U.S. real estate market, particularly in new home and commercial construction, has adversely impacted new road construction and has had and may continue to have

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adverse effects on Transportation Systems contract revenues and Roadway Sensors net sales. 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 uncertainty regarding allotment of government funds due to delays in the passage of a new Federal Highway Bill; however, Congress recently agreed to extend the current levels of funding under the previous bill through March 2012. If the conditions above continue or worsen, or uncertainties regarding funding under a new Federal Highway Bill are prolonged, 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 net sales and contract revenues are derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. 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 in October 2009, as well as delays or reductions in other state and local funding dedicated for transportation projects;
- other government budgetary constraints, cut-backs, delays or reallocation of government funding;
- performance bond requirements;

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- long purchase cycles or approval processes;
- competitive bidding and qualification requirements;
- changes in government policies and political agendas;
- 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.

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 have had 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 and many smaller regional engineering firms.

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. 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.

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We may engage in acquisitions of companies or technologies that may require us to undertake significant capital infusions and could result in disruptions of our business and diversion of resources and management attention. We have completed three acquisitions since April 2009 and, in the future, we may 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;

- 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, as well as other unanticipated accounting charges.

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 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.

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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 financing arrangements or the required governmental approval or fail to meet other required conditions, we may not be able to pursue particular projects, which could 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 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. In particular, while we have not to date experienced a material adverse impact due to the earthquake, tsunami and resulting damage to Japan's infrastructure, we could experience supply chain interruptions for products sourced from Japan.

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.

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.

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;
- changes in customer requirements;
- additional qualification requirements related to new products or components;

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- 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.

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 the United Arab Emirates in the fiscal year ended March 31, 2010. We plan to expand our international efforts in the future with respect to all 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 U.S. and each other country in which we operate;
- unexpected changes in regulatory requirements, tariffs and other trade barriers or restrictions;
- the burdens of compliance with a wide variety of foreign laws and more restrictive labor laws and obligations;

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- 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. As a smaller reporting company, for our fiscal year ending March 31, 2012, 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 the auditor attestation requirement under Section 404(b) of the Sarbanes-Oxley Act. 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.

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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;
- the long lead times associated with government contracts;
- the size, timing, rescheduling or cancellation of significant customer orders;
- our ability to control costs;

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- our ability to raise additional capital;
- the mix of our products and services sold in a quarter, which has varied and is expected to continue to vary from time to time;
- seasonality due to winter weather conditions;
- seasonality with respect to revenues from our MDSS and related weather forecasting services due to the decrease in revenues generated for such services during the spring and summer time periods;
- 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;
- 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;

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- risks and uncertainties associated with our international business;
- currency fluctuations and our ability to get currency out of certain foreign countries;
- general economic and political conditions;
- international conflicts and acts of terrorism; and
- other factors beyond our control, including but not limited, to the impact on our future revenues as a result of the recent earthquake, tsunami and related events in Japan.

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

We experienced declining or flat net sales and contract revenues in our two most recently completed fiscal years. 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.

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 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 U.S. As a result, we may not be able to protect our proprietary rights adequately in the U.S. 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

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require us to cease marketing or using certain products or technologies. We may not be able to obtain any licenses on terms acceptable to us, or at all. We also may have to indemnify certain customers or strategic partners if it is determined that we have infringed upon or misappropriated another party's intellectual property. Any of these results could adversely affect our business, financial condition and results of operations. In addition, the cost of addressing any intellectual property litigation claim, including legal fees and expenses, and the diversion of management's attention and resources, regardless of whether the claim is valid, could be significant and could seriously harm our business, financial condition and results of operations.

We may be subject to traffic related litigation. The traffic industry in general can be subject to litigation claims due to the nature of personal injuries that result from traffic accidents. As a provider of traffic engineering services, products and solutions, we have been and could in the future be subject to litigation for traffic related accidents from time to time even if our products or services had nothing to do with the particular accident. While we carry insurance against such claims, if the damages in any given action were high or we were subject to multiple lawsuits, the damages and costs could exceed the limits of our insurance coverage. If we were required to pay substantial damages as a result of these lawsuits, it may harm our business and financial condition. Even defending against unsuccessful claims could cause us to incur significant expenses and result in a diversion of management's attention.

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, pursue acquisitions or 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;

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- 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;
- 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.

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 April 2008, our common stock has traded at closing prices as low as \$0.90 per share and as high as \$2.98 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;

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- 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 new 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

On August 22, 2011, our Board of Directors approved a stock repurchase program. Under the program, we may acquire up to \$3 million of our outstanding common stock from time to time until August 2012. Purchases may be made in the open market (including pursuant to Rule 10b5-1 trading plans), in privately negotiated transactions or in block purchases, depending on market conditions, share price and other factors. The table below details our common stock repurchases for the three months ended December 31, 2011. All repurchased shares have been retired and resumed their status as authorized and unissued shares of our common stock.

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------------|----------------------------------|------------------------------|----------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|
| October 1-31, 2011 | 71,725 | \$ 1.14 | 71,725 | |
| November 1-30, 2011 | 130,993 | 1.25 | 130,993 | |
| December 1-31, 2011 | | | | |
| Total | 202,718 | \$ 1.21 | 202,718 | \$ 2,603,559 |

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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None.

ITEM 6. EXHIBITS

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

| Exhibit Number | Description | Where Located |
|-----------------------|----------------------------------------------------------------------------------------------------------------------------------------|-----------------------|
| 31.1 | Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 31.2 | Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 32.1 | Certification of the Chief Executive Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 32.2 | Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 101.INS# | XBRL Instance Document | <i>Filed herewith</i> |
| 101.SCH# | XBRL Taxonomy Extension Schema Document | <i>Filed herewith</i> |
| 101.CAL# | XBRL Taxonomy Extension Calculation Linkbase Document | <i>Filed herewith</i> |
| 101.LAB# | XBRL Taxonomy Extension Label Linkbase Document | <i>Filed herewith</i> |
| 101.PRE# | XBRL Taxonomy Extension Presentation Linkbase Document | <i>Filed herewith</i> |
| 101.DEF# | XBRL Taxonomy Definition Presentation Linkbase Document | <i>Filed herewith</i> |

Pursuant to Rule 406T of Regulation S-T, these interactive data files i) are not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, are not deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, irrespective of any general incorporation language included in any such filings, and otherwise are not subject to liability under these sections; and ii) are deemed to have complied with Rule 405 of Regulation S-T (Rule 405) and are not subject to liability under the anti-fraud provisions of the Section 17(a)(1) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 or under any other liability provision if we have made a good faith attempt to comply with Rule 405 and, after we become aware that the interactive data files fail to comply with Rule 405, we promptly amend the interactive data files.

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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 9, 2012

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)

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| Exhibit Number | Description | Where Located |
|-----------------------|----------------------------------------------------------------------------------------------------------------------------------------|-----------------------|
| 31.1 | Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 31.2 | Certification of the Principal Financial and Accounting Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 32.1 | Certification of the Chief Executive Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 32.2 | Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i> |
| 101.INS# | XBRL Instance Document | <i>Filed herewith</i> |
| 101.SCH# | XBRL Taxonomy Extension Schema Document | <i>Filed herewith</i> |
| 101.CAL# | XBRL Taxonomy Extension Calculation Linkbase Document | <i>Filed herewith</i> |
| 101.LAB# | XBRL Taxonomy Extension Label Linkbase Document | <i>Filed herewith</i> |
| 101.PRE# | XBRL Taxonomy Extension Presentation Linkbase Document | <i>Filed herewith</i> |
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