

ITERIS, INC.
Form 10-K
June 12, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended March 31, 2008

OR

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

For the transition period from to

Commission file number 001-08762

ITERIS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction
of Incorporation or Organization)

95-2588496

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

1700 Carnegie Ave, Santa Ana, California 92705

(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: **(949) 270-9400**

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Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|--------------------------------|---|
| Common Stock, \$0.10 par value | American Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: **None**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 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 a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Smaller reporting company

(Do not check if a smaller reporting company)

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

Based on the closing sale price of the registrant's common stock on the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting common stock held by nonaffiliates of the registrant was \$48,200,000. For the purposes of this calculation, shares owned by officers, directors and 10% stockholders known to the registrant have been deemed to be owned by affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of June 10, 2008, there were 33,888,002 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the registrant's definitive proxy statement for the 2008 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the fiscal year ended March 31, 2008. Except with respect to information specifically incorporated by reference in this report, the registrant's proxy statement is not

deemed to be filed as a part hereof.

ITERIS, INC.

ANNUAL REPORT ON FORM 10-K

FOR THE FISCAL YEAR ENDED MARCH 31, 2008

TABLE OF CONTENTS

| | | |
|--------------------|---|----|
| | <u>PART I</u> | 3 |
| <u>ITEM 1.</u> | <u>BUSINESS</u> | 3 |
| <u>ITEM 1A.</u> | <u>RISK FACTORS</u> | 7 |
| <u>ITEM 1B.</u> | <u>UNRESOLVED STAFF COMMENTS</u> | 15 |
| <u>ITEM 2.</u> | <u>PROPERTIES</u> | 16 |
| <u>ITEM 3.</u> | <u>LEGAL PROCEEDINGS</u> | 16 |
| <u>ITEM 4.</u> | <u>SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u> | 16 |
| | <u>PART II</u> | 17 |
| <u>ITEM 5.</u> | <u>MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES</u> | 17 |
| <u>ITEM 6.</u> | <u>SELECTED FINANCIAL DATA</u> | 19 |
| <u>ITEM 7.</u> | <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> | 20 |
| <u>ITEM 7A.</u> | <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u> | 30 |
| <u>ITEM 8.</u> | <u>FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA</u> | 30 |
| <u>ITEM 9.</u> | <u>CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE</u> | 30 |
| <u>ITEM 9A(T).</u> | <u>CONTROLS AND PROCEDURES</u> | 30 |
| <u>ITEM 9B.</u> | <u>OTHER INFORMATION</u> | 31 |
| | <u>PART III</u> | 31 |
| <u>ITEM 10.</u> | <u>DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE</u> | 31 |
| <u>ITEM 11.</u> | <u>EXECUTIVE COMPENSATION</u> | 31 |
| <u>ITEM 12.</u> | | 31 |

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SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND
MANAGEMENT AND RELATED STOCKHOLDER MATTERS

| | | |
|-----------------|--|----|
| <u>ITEM 13.</u> | <u>CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE</u> | 31 |
| <u>ITEM 14.</u> | <u>PRINCIPAL ACCOUNTING FEES AND SERVICES</u> | 32 |
| | <u>PART IV</u> | 32 |
| <u>ITEM 15.</u> | <u>EXHIBITS AND FINANCIAL STATEMENT SCHEDULES</u> | 32 |

Unless otherwise indicated in this report, the registrant, we, us and our collectively refers to Iteris, Inc. and its former subsidiary, Meyer, Mohaddes Associates, Inc., which was dissolved effective April 2006.

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

Cautionary Statement

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

PART I

ITEM 1. BUSINESS

Overview

Iteris, Inc. is a leader in the traffic management market that focuses on the development and application of advanced technologies that reduce traffic congestion, minimize the environmental impact of traffic congestion and improve the safety of surface transportation systems. By combining outdoor image processing, traffic engineering and information technology, we offer a broad range of Intelligent Transportation Systems and driver safety solutions to customers worldwide.

Our proprietary image recognition systems include Vantage and AutoVue. Vantage is a video vehicle detection system that detects the presence of vehicles on roadways. Vantage systems are used at signalized intersections to enable a more efficient allocation of green signal time and are also used for incident detection and highway traffic data collection applications. AutoVue Lane Departure Warning (LDW) systems consist of a small windshield mounted sensor that uses proprietary software to detect and warn drivers of unintended lane departures. To date, we and our strategic partner have sold approximately 90,000 production AutoVue LDW systems for use on car and truck platforms in the North American and European markets. We believe that our AutoVue LDW technology is a broad sensor platform that, through additional software development, may be expanded to incorporate additional safety and convenience features.

Our transportation management systems business includes transportation engineering and consulting services focused on the planning, design, development and implementation of software-based systems that integrate sensors, video surveillance, computers and advanced communications equipment to enable public agencies to monitor, control and direct traffic flow, assist in the quick dispatch of emergency crews and distribute real-time information about traffic conditions. Our services include planning, design and implementation of surface transportation infrastructure

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systems. We perform analysis and study goods movement, commercial vehicle operations, travel demand forecasting and systems engineering, and identify mitigation measures to reduce traffic congestion. These services and systems are primarily sold to local, state and national transportation agencies in the United States. Our transportation management systems business is largely dependent upon governmental funding and budgetary issues. The Federal Highway Bill that was passed in August 2005 provided for a significant increase in transportation funding over the following six years. We believe the recent expansion of our transportation management systems business was due in part to the passage of the Federal Highway Bill, combined with the expansion of transportation funds at state and local agencies throughout the country. The 2005 Federal Highway Bill is set to expire during 2009.

We currently operate in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. The Vehicle Sensors segment is comprised of all activities related to our AutoVue LDW systems for vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. See Note 12 to the accompanying consolidated financial statements for further discussion of our operating segments.

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We were originally incorporated in Delaware in 1987. In October 2004, we completed a merger with our majority-owned subsidiary, Iteris, Inc. (the Iteris Subsidiary), and officially changed our corporate name to Iteris, Inc.

Sales, Marketing and Principal Customers

We sell our Vantage vehicle detection systems through indirect sales channels comprised of independent dealers in the United States and Canada who sell integrated systems and related products to the traffic management market, as well as directly to the traffic management market using a combination of our own sales personnel and an outside sales organization. Our independent dealers are primarily responsible for sales, installation and support of Vantage systems. These dealers maintain an inventory of demonstration traffic products from various manufacturers including our Vantage vehicle detection systems and sell directly to government agencies and installation contractors. These dealers often have long-term arrangements with the government agencies in their territory for the supply of various products for the construction and renovation of traffic intersections. We hold technical training classes for dealers and end users and maintain a full-time staff of customer support technicians to provide technical assistance when needed.

Our marketing strategy for AutoVue is to establish it as the leading platform for in-vehicle video sensing for heavy trucks and passenger cars. We sell AutoVue LDW systems directly to heavy truck manufacturers and to U.S. truck fleets, and our AutoVue LDW system is currently offered as an option on certain heavy trucks, including Mercedes-Benz, MAN, Iveco, DAF, Scania, Freightliner and FUSO, as well as Neoplan and MAN luxury bus and coach lines. We market the licensing of our LDW technology to manufacturers of passenger automobiles through an exclusive strategic relationship with Valeo Schalter and Sensuren GmbH (Valeo), an independent automotive supplier. In connection with this marketing effort, we provide specific contract engineering services, technical marketing and sales support to Valeo, which to date has enabled the launch of our LDW technology on three Infiniti car platforms. We plan to continue to provide technical marketing and sales support to Valeo in our efforts to win new original equipment manufacturer (OEM) customers for the passenger car market as well as contract engineering services related to the possible launch of new platforms that include our AutoVue LDW system.

We market and sell our transportation management systems and traveler information services directly to government agencies pursuant to negotiated contracts that involve competitive bidding and specific qualification requirements. Most of our contracts with federal, state and municipal customers provide for cancellation or renegotiation at the option of the customer upon reasonable notice and fees paid for modification. We use selected members of our engineering team divided on a regional basis to serve in sales and business development functions. We do not engage in sales of transportation management systems and traveler information services outside of the U.S. Sales of our transportation management systems contracts generally involve long lead times and require extensive specification development, evaluation and price negotiations.

A large portion of our revenues are derived from sales to federal, state and local government agencies. Our largest customer accounted for 7.3% of total net sales and contract revenues in the fiscal year ended March 31, 2008 (Fiscal 2008).

Manufacturing and Materials

We use contract manufacturers to build subassemblies that are used in our Vantage products. Additionally, we procure certain components from qualified suppliers, both globally and locally, and use multi-sourcing strategies when technically and economically feasible to mitigate supply risk. These subassemblies and components are delivered to our Santa Ana facility where they go through final assembly and testing prior to shipment to our customers. Our manufacturing activities are conducted in approximately 9,000 square feet of space at our Santa Ana facility. Production volume at our subcontractors is based upon quarterly forecasts that we adjust on a monthly basis to control inventory levels. For sales

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of AutoVue LDW systems to the truck market, we subcontract the manufacture of our AutoVue LDW systems to one primary manufacturer, and our internal processes are limited primarily to testing and final verification. For AutoVue LDW sales to the passenger car market, all manufacturing will be performed by Valeo; however, we plan to continue to provide engineering support to Valeo. We currently do not manufacture any of the hardware used in the transportation management and traveler information systems that we design and implement. Our production facility is currently ISO 9001 certified.

Customer Support and Services

We provide warranty service and support for our Vantage and AutoVue products, as well as follow-up service and support for which we charge separately. Service revenue accounted for less than 1.0% of total net sales and contract revenues for Fiscal 2008. We believe customer support is a key competitive factor.

Backlog

Our backlog of unfulfilled firm orders was approximately \$26.8 million as of March 31, 2008, which was comprised of \$900,000 related to Roadway Sensors, \$1.3 million related to Vehicle Sensors and \$24.6 million related to Transportation Systems. Substantially all of the backlog for Roadway Sensors and Vehicle Sensors is expected to be recognized as revenue in the fiscal year ending March 31, 2009 (Fiscal 2009), while approximately 60% of Transportation Systems backlog is expected to be recognized as revenue in Fiscal 2009. At March 31, 2007, we had backlog of approximately \$25.7 million, which was comprised of \$3.5 million related to Roadway Sensors, \$2.1 million related to Vehicle Sensors and \$20.1 million related to Transportation Systems. All backlog as of March 31, 2007 for Roadway Sensors and Vehicle Sensors was recognized as revenue in Fiscal 2008 while 45% of March 31, 2007 backlog for Transportation Systems was recognized as revenue in Fiscal 2008. Pursuant to the customary terms of our agreements with government contractors and other customers, customers can generally cancel or reschedule orders with little or no penalties. Lead times for the release of purchase orders often depend upon the scheduling and forecasting practices of our individual customers, which also can affect the timing of the conversion of our backlog into revenues. For these reasons, among others, our backlog at a particular date may not be indicative of our future revenues, in particular for Roadway Sensors and Vehicle Sensors.

Product Development

Most of our development activities are conducted at our principal facilities in Santa Ana, California. Our company-sponsored research and development costs and expenses were approximately \$3.6 million for Fiscal 2008, \$4.0 million for the fiscal year ended March 31, 2007 (Fiscal 2007), and \$5.2 million for the fiscal year ended March 31, 2006 (Fiscal 2006). We expect to continue to pursue significant product development programs and incur significant research and development expenditures.

Competition

We generally face significant competition in each of our target markets. Increased competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, financial condition and results of operations. While AutoVue has historically been the only established commercially-available lane departure warning system used in the U.S. and in Europe in the heavy truck market, we have recently experienced increased competition from new competitors in this market. Potential competitors of AutoVue include Delphi Automotive Systems Corporation, NEC Corporation and Hitachi Ltd. in Japan and Robert Bosch GmbH in Europe, as well as Siemens, Continental Tavis, Visteon and Cognex, which are currently developing video sensor technologies for the vehicle industry that could be used for lane departure warning systems. In the market for our Vantage vehicle detection systems, we compete with manufacturers of other above ground video camera detection systems such as Econolite Control Products, Inc., Traficon, N.V., Quixote, and other non-intrusive detection devices including microwave, infrared, ultrasonic and magnetic detectors, as well as manufacturers and installers of in-pavement inductive loop products.

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The transportation management and traveler information systems market is highly fragmented and is subject to evolving national and regional quality and safety standards. Our competitors vary in number, scope and breadth of the products and services they offer. Our competitors in advanced transportation management and traveler information systems include national corporations such as Transcore, Siemens, Telvent Farradyne, Kimley-Horn and Associates, Inc. and Delcan. Our competitors in transportation engineering, planning and design include major firms such as Parsons Brinkerhoff, Inc., URS, HNTB and Parsons Transportation Group, Inc., as well as many smaller regional engineering firms.

In general, the markets for the products and services we offer are highly competitive and are characterized by rapidly changing technology and evolving standards. Many of our current and prospective competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, technical, manufacturing, distribution and marketing resources than us. As a result, they may be able to adapt more quickly to new or emerging standards or technologies or to devote greater resources to the promotion and sale of their products. It is also possible that new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We believe that our ability to compete effectively in our target markets will depend on a number of factors, including the success and timing of our new product development, the compatibility of our products with a broad range of computing systems, product quality and performance, reliability, functionality, price, and service and technical support. Our failure to provide services and develop and market products that compete successfully with those of other suppliers and consultants in our target markets would have a material adverse effect on our business, financial condition and results of operations.

Intellectual Property and Proprietary Rights

Our ability to compete effectively depends in part on our ability to develop and maintain the proprietary aspects of our technology. Our policy is to obtain appropriate proprietary rights protection for any potentially significant new technology acquired or developed by us. We currently hold ten U.S. patents, which expire commencing in 2012, and have six U.S. patent applications pending relating to our outdoor image processing techniques used in our AutoVue systems. Nine of our patents relate specifically to our AutoVue technology and provide a basis for enhanced functionality for rain sensing and improved performance. We believe that our other patents, while important for our technology platforms, are less critical to our near term product strategy. We cannot assure you that any new patents will be granted pursuant to any outstanding or subsequent applications.

In addition to patent laws, we rely on copyright and trade secret laws to protect our proprietary rights. We attempt to protect our trade secrets and other proprietary information through agreements with customers and suppliers, proprietary information agreements with our employees and consultants, and other similar measures. We do not have any material licenses or trademarks other than those relating to product names. We cannot be certain that we will be successful in protecting our proprietary rights. While we believe our patents, patent applications, software and other proprietary know-how have value, changing technology makes our future success dependent principally upon our employees' technical competence and creative skills for continuing innovation.

Litigation may be necessary in the future to enforce our proprietary rights, to determine the validity and scope of the proprietary rights of others, or to defend us against claims of infringement or invalidity by others. An adverse outcome in such litigation or similar proceedings could subject us to significant liabilities to third parties, require disputed rights to be licensed from others or require us to cease marketing or using certain products, any of which could have a material adverse effect on our business, financial condition and results of operations. In addition, the cost of addressing any intellectual property litigation claim, both in legal fees and expenses, as well as from the diversion of management's resources, regardless of whether the claim is valid, could be significant and could have a material adverse effect on our business, financial condition and results of operations.

Employees

We refer to our employees as associates. As of June 9, 2008, we employed an aggregate of 268 associates, including 54 associates in general management, administration and finance; 34 associates in sales and marketing; 144 associates in engineering and product development; 23 associates in operations, manufacturing and quality; and 13 associates in customer service. None of our associates are represented by a labor union, and we have never experienced a work stoppage.

Government Regulation

Our manufacturing operations are subject to various federal, state and local laws and regulations, including those restricting the discharge of materials into the environment. We are not involved in any pending or, to our knowledge, threatened governmental proceedings, which would require curtailment of our operations because of such laws and regulations. We continue to expend funds in connection with our compliance with applicable environmental regulations. These expenditures have not, however, been significant in the past, and we do not expect any significant expenditure in the near future. Currently, compliance with foreign laws has not had a material impact on our business and is not expected to have a material impact in the near future.

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 subsequent reports on Forms 10-Q and 8-K, before deciding to buy, sell or hold our common stock. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occurs, our business, financial condition or results of operations could be seriously harmed. In that event, the market price for our common stock could decline and you may lose all or part of your investment.

We May Need To Raise Additional Capital In The Future, Which May Not Be Available On Terms Acceptable To Us, Or At All. Until recently we have historically generated significant net losses and operating losses, and have experienced volatility in our cash flows from operations ranging from positive cash flows from operations of \$7.6 million in Fiscal 2008 to negative cash flows from operations of \$2.0 million in Fiscal 2007. Additionally, we failed to meet certain debt covenants under our prior credit agreement during two fiscal quarters, prior to the replacement of that credit facility in October 2006. Furthermore, as of March 31, 2008, we had \$7.8 million in subordinated convertible debentures outstanding that are due in full in May 2009. Should the holders of the convertible debentures not elect to convert the principal into shares of our common stock, we may need to raise additional capital to refinance this debt.

At March 31, 2008, we had \$421,000 of cash and cash equivalents and relied on our line of credit to fund our operations. We may need to raise additional capital in the near future to fund our operations or to repay indebtedness. Such additional capital may be raised through bank borrowings, or other debt or equity financings. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all, and such additional financing may result in further dilution to our stockholders.

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

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

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- 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 repay our subordinated convertible debentures; and
- general economic conditions, including the effects of the current economic slowdown and international conflicts.

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

We Have Historically Experienced Substantial Losses And May Experience Losses In The Future. Although we have achieved net income in our prior three fiscal years, we experienced a net loss of \$11.3 million in the year ended March 31, 2005 and significant net losses in prior years. We cannot assure you that we will be able to sustain or improve our financial performance, or that we will be able to continue to achieve profitability on a quarterly or annual basis in the future. Most of our expenses are fixed in advance. As such, we generally are unable to reduce our expenses significantly in the short-term to compensate for any unexpected delay or decrease in anticipated revenues. As a result, we may continue to experience operating losses and net losses, which would make it difficult to fund our operations and achieve our business plan, and could cause the market price of our common stock to decline.

If Our Internal Controls Over Financial Reporting Do Not Comply With The Requirements Of The Sarbanes-Oxley Act, Our Business And Stock Price Could Be Adversely Affected. Along with our independent registered public accounting firm, we will be evaluating the effectiveness of our internal controls over financial reporting to comply with Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 currently requires us to evaluate the effectiveness of our internal controls over financial reporting at the end of each fiscal year beginning in our fiscal year ending March 31, 2008 and to include a management report assessing the effectiveness of our internal controls over financial reporting in all annual reports beginning with our Annual Report on Form 10-K for the fiscal year ending March 31, 2008. Section 404 also requires our independent accountant to attest to, and report on, management's assessment of our internal controls over financial reporting beginning in our fiscal year ending March 31, 2009. We may not be able to complete our Section 404 compliance on a timely basis, and even if we timely complete our compliance requirements, our independent auditors may still conclude that our internal controls over financial reporting are not effective.

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

As of March 31, 2005, we became aware of a material weakness in our internal controls related to the accounting for the consolidation of our deferred compensation savings plan and certain contract administration. Based on our evaluation, our management concluded that, as of March 31, 2004, our internal control over financial reporting was not effective due to the existence of one material weakness. The weakness was immediately corrected. We cannot assure you that we or our independent registered public accounting firm will not identify additional material weaknesses in our internal controls. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than

a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. If our internal controls over financial reporting are not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

We Depend On Government Contracts And Subcontracts, And Because Many Of Our Government Contracts Are Fixed Price Contracts, Higher Than Anticipated Costs Will Reduce Our Profit And Could Adversely Impact Our Operating Results. A significant portion of our sales are derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. Government contracts represented approximately 38.1%, 37.8% and 38.3% of our total net sales and contract revenues for the years ended March 31, 2008, 2007 and 2006, respectively. We anticipate that revenue from government contracts will continue to remain a significant portion of our net sales and contract revenues. Government business is, in general, subject to special risks and challenges, including:

- long purchase cycles or approval processes;

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

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

New Environmental Regulations May Result In A Decline In Our AutoVue Sales and Royalties. Environmental regulations in Europe were modified and became effective in 2006, which required more stringent emissions compliance in new trucks manufactured in Europe after 2006. These regulations caused the cost of certain trucks to increase significantly and caused a decline in new truck sales in Europe. Similar regulations were exacted in North America that impacted diesel engines built after January 2007. North America heavy truck sales in 2007 and the first quarter of 2008 declined significantly as compared to the prior year, which we believe was at least in part a result of large 2006 prebuys of heavy trucks made in anticipation of the new North America emission standards. We may experience a further decline in our LDW sales to truck OEMs related to these stricter regulations. Additionally, we may experience future declines in our LDW sales to truck OEMs as a result of future regulations such as these.

We May Experience Production Gaps Which Could Materially And Adversely Impact Our Sales And Financial Results And The Ultimate Acceptance Of Our Products. It is possible that we could experience unforeseen quality control issues or part shortages as we increase production to meet current demand for our products. We have historically used single suppliers for certain of our components in our AutoVue and Vantage products. Should any such delay or disruption occur, our future sales will likely be materially and adversely affected. Additionally, we rely heavily on select contract manufacturers to produce many of our products. Although we believe our contract manufacturers have sufficient capacity to meet our production schedules for the foreseeable future and we believe we could find alternative contract manufacturing sources if necessary, we could experience a production gap if for any reason our contract manufacturers were unable to meet our production requirements.

We Depend Upon Valeo To Market Our AutoVue Technologies For The OEM Passenger Car Market. We have granted Valeo the exclusive right to sell and manufacture our AutoVue LDW system to the worldwide passenger car market in exchange for royalty payments for each AutoVue unit sold. As such, the future success and broad market acceptance of our AutoVue technologies in the passenger car market will depend upon Valeo's ability to manufacture, market and sell our technologies, and to convince more OEM passenger car manufacturers to adopt our technologies. To date, we have not generated significant royalties from Valeo's efforts and have only been designed into one car OEM product line. If Valeo does not devote considerable resources and aggressively pursue opportunities, our expansion into the passenger car market could be adversely affected.

We May Be Unable To Attract And Retain Key Personnel, Which Could Seriously Harm Our Business. Due to the specialized nature of our business, we are highly dependent on the continued service of our executive officers and other key management, engineering and technical personnel. The loss of Abbas Mohaddes, our Chief Executive Officer, or any of the other executive officers or key members of management could adversely affect our business, financial condition or results of operations. Our success will also depend in large part upon our ability to continue to attract, retain and motivate qualified engineering and other highly skilled technical personnel. In particular, the future success of our Transportation Systems segment will depend on our ability to hire additional qualified engineers and planners. Competition for qualified employees, particularly development engineers, is intense. We may not be able to continue to attract and retain sufficient numbers of such highly skilled employees. Our inability to attract and retain additional key employees or the loss of one or more of our current key employees could adversely affect our business, financial condition and results of operations.

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

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

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

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

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

The Markets In Which We Operate Are Highly Competitive And Have Many More Established Competitors, Which Could Adversely Affect Our Sales Or The Market Acceptance Of Our Products. We compete with numerous other companies in our target markets including, but not limited to, large, multinational corporations, which include tier one automotive suppliers, and many smaller regional engineering firms. We expect such competition to increase due to technological advancements, industry consolidations and reduced barriers to entry. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could seriously harm our business, financial condition and results of operations. In Fiscal 2007, we began to experience more competition in our Roadway Sensors segment as the Department of Transportation in one of our largest sales territories moved to a multi-source contracting environment from one in which we were the sole supplier. In addition, one of the other developers of LDW systems was

acquired by a larger company during Fiscal 2007. While this developer has not been a material competitor to date, we may experience more competition from this provider as a result of its greater access to resources from its acquirer, and additional competitors may enter this market in the future. Furthermore, awareness of LDW technology is increasing and other market players are attempting to develop competing technologies, which may contain improvements or added features beyond those offered by our LDW systems. Should such efforts be successful, this could erode our ability to successfully market and sell our LDW systems to new and existing customers.

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

An Economic Slowdown Could Lead To Reduced Or Delayed Government Funding For Transportation Infrastructure And Initiatives And Decreased Availability Of Financial Capital For Our Customers, Causing A Decline In Our Revenues. Concerns about inflation, decreased consumer confidence, and reduced corporate profits and capital spending have resulted in a downturn in worldwide economic conditions, particularly in the United States. These unfavorable economic conditions may have a negative impact on customer orders (and also may result in decreased sales of automobiles and trucks that incorporate our LDW systems). Such concerns may result in cancellations and rescheduling of backlog. In addition, the recent decline in the U.S. real estate market, particularly in new home construction, has adversely impacted new road construction and could result in a decline in Roadway Sensor and Vehicle Sensor net sales and Transportation Systems contract revenues. Any of the foregoing economic conditions make it extremely difficult for our customers, our suppliers and us to accurately forecast and plan future business activities and could result in a decline in our net sales and contract revenues. If such conditions continue or worsen, our business, financial condition and results of operations could be materially and adversely affected.

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

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

- changes in our pricing policies and the pricing policies of our suppliers and competitors, pricing

concessions on volume sales, as well as increased price competition in general;

- the long lead times associated with government contracts or required by vehicle manufacturers;
- delays in government contracts and funding from time to time;
- declines in new home construction and related road construction;
- our ability to control costs;
- our ability to raise additional capital;
- the mix of our products and services sold in a quarter, which mix has varied and is expected to continue to vary from time to time;

- seasonality due to winter weather conditions;
- international conflicts and acts of terrorism;
- our ability to develop, introduce, patent, market and gain market acceptance of new products, applications and product enhancements in a timely manner, or at all;
- market acceptance of the products incorporating our technologies and products;
- the size, timing, rescheduling or cancellation of significant customer orders;
- the introduction of new products by competitors;
- the availability and cost of components used in the manufacture of our products;
- our success in expanding and implementing our sales and marketing programs;
- the effects of technological changes in our target markets;
- the amount of our backlog at any given time;
- the nature of our government contracts;
- deferrals of customer orders in anticipation of new products, applications or product enhancements;

- risks and uncertainties associated with our international business;
- currency fluctuations and our ability to get currency out of certain foreign countries; and
- general economic and political conditions.

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

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

- potential disruption of our ongoing business and the diversion of our resources and management's attention;
- the failure to retain or integrate key acquired personnel;
- the challenge of assimilating diverse business cultures, and the difficulties in integrating the operations, technologies and information system of the acquired companies;
- increased costs to improve managerial, operational, financial and administrative systems and to eliminate duplicative services;
- the incurrence of unforeseen obligations or liabilities;

- potential impairment of relationships with employees or customers as a result of changes in management; and
- increased interest expense and amortization of acquired intangible assets.

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

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

If We Do Not Keep Pace With Rapid Technological Changes And Evolving Industry Standards, We Will Not Be Able To Remain Competitive And There Will Be No Demand For Our Products. Our markets are in general characterized by the following factors:

- rapid technological advances;
- downward price pressure in the marketplace as technologies mature;
- changes in customer requirements;
- additional qualification requirements related to new products or components;
- frequent new product introductions and enhancements;

- inventory issues related to transition to new or enhanced models; and
- evolving industry standards and changes in the regulatory environment.

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

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

Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Litigation may also be necessary to defend against claims of infringement or invalidity by others. An adverse outcome in litigation or any similar proceedings could subject us to significant liabilities to third parties, require us to license disputed rights from others or require us to cease marketing or using certain products or

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

The Trading Price Of Our Common Stock Is Highly Volatile. The trading price of our common stock has been subject to wide fluctuations in the past. Since January 2000, our Class A common stock (now known as our common stock) has traded at prices as low as \$0.45 per share and as high as \$29.44 per share. The market price of our common stock could continue to fluctuate in the future in response to various factors, including, but not limited to:

- quarterly variations in operating results;
- our ability to control costs, improve cash flow and sustain profitability;
- our ability to raise additional capital;
- shortages announced by suppliers;
- announcements of technological innovations or new products or applications by our competitors, customers or us;
- transitions to new products or product enhancements;
- acquisitions of businesses, products or technologies;
- the impact of any litigation;
- changes in investor perceptions;

- government funding, political agendas and other budgetary issues;
- changes in earnings estimates or investment recommendations by securities analysts; and
- international conflicts, political unrest and acts of terrorism.

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.

Our International Business Operations May Be Threatened By Many Factors That Are Outside Of Our Control. We currently market our AutoVue and Vantage products internationally and we anticipate that our international operations will expand in the near future. International business operations are subject to various inherent risks including, among others:

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

- unexpected changes in regulatory requirements, tariffs and other trade barriers or restrictions;
- the burdens of compliance with a wide variety of foreign laws and more restrictive labor laws and obligations;
- difficulties in managing and staffing international operations;
- potentially adverse tax consequences; and
- reduced protection for intellectual property rights in some countries.

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

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

We Could Experience Negative Financial Impacts Arising From Developments In Contingencies Created Under Our Previous Structure Or By Former Subsidiaries. Although we divested ourselves of all business units prior to October 2004, with the exception of our Iteris business, from time to time we could experience unforeseen developments in contingencies related to our former subsidiaries. For example, in July 2006 we entered into a settlement agreement in connection with a lawsuit brought against Mariner Networks, Inc., one of our former subsidiaries, by one of Mariner's suppliers, pursuant to which we issued 88,912 shares of our common stock to this supplier (valued at \$213,000 as of the date of issuance), paid this supplier \$125,000 on October 20, 2006 and are required to pay an additional \$350,000 in 36 equal monthly installments of \$9,700 beginning in November 2006. Although we are not aware of any other material contingencies, it is possible that other matters could be brought against us in connection with activities related to former subsidiaries and that such matters could materially and adversely affect our financial results and cash flows.

Some Of Our Directors, Officers And Their Affiliates Can Control The Outcome Of Matters That Require The Approval Of Our Stockholders, And Accordingly We Will Not Be Able To Engage In Certain Transactions Without Their Approval. As of March 31, 2008, our officers and directors beneficially owned approximately 11% of the outstanding shares of our common stock (and approximately 15% of our common stock when including options, warrants and other convertible securities held by them which are currently exercisable or convertible or will become exercisable or convertible within 60 days

after March 31, 2008). As a result of their stock ownership, our management will be able to influence the election of our directors and the outcome of corporate actions requiring stockholder approval, such as mergers and acquisitions, regardless of how our other stockholders may vote. This concentration of voting control may have a significant effect in delaying, deferring or preventing a change in our management or change in control and may adversely affect the voting or other rights of other holders of common stock.

Certain Anti-Takeover Provisions May Affect The Price Of Our Common Stock And Discourage A Third Party From Acquiring Us. Certain provisions of our certificate of incorporation could make it difficult for a third party to acquire us, even though an acquisition might be beneficial to our stockholders. Such provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. Under the terms of our certificate of incorporation, our Board of Directors is authorized to issue, without stockholder approval, up to 2,000,000 shares of preferred stock with voting, conversion and other rights and preferences superior to those of our common stock. Our future issuance of preferred stock could be used to discourage an unsolicited acquisition proposal.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Our headquarters and principal operations are housed in approximately 52,000 square feet of leased space located at 1700 Carnegie Avenue, Santa Ana, California, for which we currently pay a monthly lease rate of \$102,000, exclusive of certain utility costs. The Santa Ana facility lease expires in 2015 and contains an option to extend the lease for an additional five years at the market rate at that time.

For additional information regarding our obligations under property leases, see Note 6 of Notes to Consolidated Financial Statements, included in Part IV, Item 15 of this report.

ITEM 3. LEGAL PROCEEDINGS

The information set forth under Note 6 of Notes to Consolidated Financial Statements, included in Part IV, Item 15 of this report, is incorporated herein by reference.

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

No matters were submitted to a vote of our security holders during the three months ended March 31, 2008.

PART II**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the American Stock Exchange (AMEX) under the symbol ITI . The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported by AMEX:

| | Common Stock | |
|----------------------------------|--------------|---------|
| | High | Low |
| Fiscal 2008 | | |
| Quarter Ended June 30, 2007 | \$ 2.66 | \$ 2.11 |
| Quarter Ended September 30, 2007 | 2.50 | 2.00 |
| Quarter Ended December 31, 2007 | 4.20 | 2.18 |
| Quarter Ended March 31, 2008 | 4.06 | 1.94 |
| Fiscal 2007 | | |
| Quarter Ended June 30, 2006 | \$ 2.69 | \$ 2.10 |
| Quarter Ended September 30, 2006 | 2.69 | 2.26 |
| Quarter Ended December 31, 2006 | 2.69 | 1.38 |
| Quarter Ended March 31, 2007 | 2.76 | 2.15 |

On June 10, 2008, the last reported sales price of our common stock on the AMEX was \$2.72. As of June 10, 2008, we had 456 holders of record of our common stock according to information furnished by our transfer agent.

Dividend Policy

We have never paid or declared cash dividends on our common stock, and have no current plans to pay such dividends in the foreseeable future. We currently intend to retain any earnings for working capital and general corporate purposes. The payment of any future dividends will be at the discretion of our Board of Directors and will depend upon a number of factors, including, but not limited to, future earnings, the success of our business, our capital requirements, our general financial condition and future prospects, general business conditions, the consent of our lender and such other factors as the Board of Directors may deem relevant.

Stock Performance Graph

The graph below shows the cumulative total return on investment assuming an investment of \$100 on March 31, 2003 in our common stock, the NASDAQ Stock Market Index and the same peer group used by us last year, which is made up of the remaining members of the index used by us in prior years, the Media General Industry Group 836 for Diversified Electronics, which is no longer a published index. Our common stock is currently listed on the AMEX under the symbol ITI and began trading on such exchange on December 9, 2004. Our common stock was listed on the NASDAQ SmallCap Market (now called the NASDAQ Capital Market) from April 2002 to August 2003 and quoted on the OTC Bulletin Board from August 2003 to December 2004. The total stockholder return assumes reinvestment of dividends on a daily basis, although cash dividends have not been declared on our common stock. The stockholder returns shown in the following graph are not necessarily indicative of future performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Iteris, Inc., The NASDAQ Composite Index

And A Peer Group

* \$100 invested on 3/31/03 in stock or index-including reinvestment of dividends. Fiscal year ending March 31.

Measurement Period

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| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---------------------------|--------|--------|--------|--------|--------|--------|
| Iteris, Inc. Common Stock | 100.00 | 606.06 | 369.70 | 400.00 | 348.48 | 350.00 |
| NASDAQ Composite | 100.00 | 151.01 | 152.38 | 181.06 | 189.63 | 177.49 |
| Peer Group | 100.00 | 181.83 | 138.87 | 182.74 | 186.37 | 163.80 |

Notwithstanding anything to the contrary set forth in any of our previous or future filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, that might incorporate this report or future filings made by us under those statutes, the stock performance graph is not deemed filed with the Securities and Exchange Commission and shall not be deemed incorporated by reference into any prior filings or into any future filings made by us under those statutes.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected consolidated financial data for each of the five fiscal years ended March 31, 2008. The statement of operations and balance sheet data for the years ended and as of March 31, 2008, 2007, 2006, 2005, and 2004 are derived from our audited consolidated financial statements. The accompanying consolidated financial statements have been restated to reflect the classification and presentation of our former subsidiaries, Broadcast, Inc., Zyfer Inc., and MAXxess Systems, Inc., as discontinued operations for all periods presented. The following information should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and with our consolidated financial statements and the related notes thereto included elsewhere in this report.

| | Fiscal Year Ended March 31, | | | | |
|--|---------------------------------------|-----------|-----------|-------------|-----------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (in thousands, except per share data) | | | | |
| Consolidated Statement of Operations Data: | | | | | |
| Net sales and contract revenues: | | | | | |
| Net sales | \$ 40,326 | \$ 36,248 | \$ 31,156 | \$ 29,062 | \$ 23,470 |
| Contract revenues | 24,837 | 22,049 | 19,330 | 17,335 | 21,813 |
| Total net sales and contract revenues | 65,163 | 58,297 | 50,486 | 46,397 | 45,283 |
| Costs of net sales and contract revenues: | | | | | |
| Cost of net sales (a) | 20,499 | 19,829 | 16,493 | 15,925 | 12,758 |
| Cost of contract revenues (a) | 16,367 | 14,460 | 12,600 | 13,789 | 14,712 |
| Gross profit | 28,297 | 24,008 | 21,393 | 16,683 | 17,813 |
| Operating expenses: | | | | | |
| Selling, general and administrative (a) | 17,289 | 16,003 | 15,410 | 20,543 | 13,712 |
| Research and development (a) | 3,566 | 4,030 | 5,217 | 6,236 | 3,923 |
| Amortization of intangible assets | 147 | 147 | 147 | 114 | |
| Disposal of fixed assets | | | | 422 | |
| Acquired in-process research and development | | | | 140 | |
| Total operating expenses | 21,002 | 20,180 | 20,774 | 27,455 | 17,635 |
| Operating income (loss) | 7,295 | 3,828 | 619 | (10,772) | 178 |
| Non-operating income (expense): | | | | | |
| Other income (expense), net | 252 | (653) | 35 | 1,054 | 1,003 |
| Interest expense, net | (1,284) | (1,600) | (1,459) | (1,178) | (123) |
| Income (loss) from continuing operations before income taxes and minority interest | 6,263 | 1,575 | (805) | (10,896) | 1,058 |
| Income tax benefit (provision) | 5,900 | 1,343 | 885 | 94 | (100) |
| Minority interest in earnings of subsidiary | | | | (526) | (2,813) |
| Income (loss) from continuing operations | 12,163 | 2,918 | 80 | (11,328) | (1,855) |
| Income from discontinued operations, net of taxes | | | | | 1,215 |
| Net income (loss) | \$ 12,163 | \$ 2,918 | \$ 80 | \$ (11,328) | \$ (640) |
| Basic earnings (loss) per share: | | | | | |
| Continuing operations | \$ 0.37 | \$ 0.10 | \$ 0.00 | \$ (0.45) | \$ (0.09) |
| Discontinued operations | | | | | 0.06 |
| Basic earnings (loss) per share | \$ 0.37 | \$ 0.10 | \$ 0.00 | \$ (0.45) | \$ (0.03) |
| Diluted earnings (loss) per share: | | | | | |
| Continuing operations | \$ 0.35 | \$ 0.09 | \$ 0.00 | \$ (0.45) | \$ (0.09) |
| Discontinued operations | | | | | 0.06 |
| Diluted earnings (loss) per share | \$ 0.35 | \$ 0.09 | \$ 0.00 | \$ (0.45) | \$ (0.03) |

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| | | | | | |
|--|--------|--------|--------|--------|--------|
| Shares used in calculating basic earnings (loss) per share | 32,723 | 29,698 | 28,182 | 25,284 | 19,454 |
| Shares used in calculating diluted earnings (loss) per share | 34,713 | 33,348 | 32,737 | 25,284 | 19,454 |

(a) Includes stock-based compensation expense as follows:

| | | | | | | | | | |
|---|----|-----|----|-----|----|-----|----|--------|----|
| Cost of net sales | \$ | 3 | \$ | 13 | \$ | 27 | \$ | 280 | \$ |
| Cost of contract revenues | | 14 | | 60 | | 205 | | 2,391 | |
| Selling, general and administrative expense | | 266 | | 195 | | 364 | | 7,063 | |
| Research and development expense | | 7 | | 20 | | 129 | | 2,043 | |
| Total stock-based compensation expense | \$ | 290 | \$ | 288 | \$ | 725 | \$ | 11,777 | \$ |

| | 2008 | 2007 | At March 31, 2006 (in thousands) | 2005 | 2004 |
|---|-----------|-----------|--|-----------|----------|
| Consolidated Balance Sheet Data: | | | | | |
| Working capital | \$ 14,948 | \$ 6,979 | \$ 3,009 | \$ 2,197 | \$ 9,369 |
| Total assets | 65,645 | 55,250 | 49,633 | 46,656 | 30,065 |
| Long-term debt (less current portion) | 7,566 | 9,760 | 11,374 | 10,315 | 891 |
| Accumulated deficit | (95,499) | (107,438) | (110,356) | (110,436) | (99,108) |
| Total stockholders' equity (deficit) | 43,211 | 25,687 | 18,635 | 17,462 | (1,076) |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis in conjunction with our Consolidated Financial Statements and related Notes thereto included in Part IV, Item 15 of this report and the Risk Factors section in Item 1A, as well as other cautionary statements and risks described elsewhere in this report, before deciding to purchase, hold or sell our common stock.

Overview

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

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

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

Our AutoVue LDW systems consist of a small windshield mounted sensor that uses proprietary software to detect and warn drivers of unintended lane departures. In excess of 90,000 production AutoVue units have been sold for car and truck platforms in the North American and European markets. Our AutoVue LDW systems are currently qualified as an option on certain heavy trucks, including Mercedes-Benz, MAN, Iveco, DAF, Scania, Freightliner and FUSO, as well as Neoplan and MAN luxury bus and coach lines. In North America, our LDW systems are sold primarily to truck fleets, and to date, 65 U.S. heavy truck fleets have selected our LDW systems, representing an estimated 45,000 vehicles.

In September 2003, we entered into an agreement with Valeo Schalter and Sensuren GmbH (Valeo), pursuant to which we granted Valeo the exclusive right to sell and manufacture our AutoVue LDW systems to the worldwide passenger car market in exchange for royalty payments for

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each AutoVue LDW unit sold. To date, royalty payments from Valeo have not been significant. Pursuant to this agreement, we also provide specific contract engineering services, technical marketing and sales support to Valeo to enable the incorporation of our LDW technology on three Infiniti platforms, the FX, M and EX, where the device is offered as part of various option packages. Valeo is currently in discussions to provide our LDW system to other passenger car OEMs; however, we cannot assure you that such discussions will be successful. We plan to continue to provide technical marketing and sales support to Valeo in our efforts to win new OEM customers for the passenger car market as well as contract engineering services related to the possible launch of new Infiniti platforms that include our LDW system. We believe that AutoVue is a broad sensor platform that, through additional software development, may be expanded to incorporate additional safety and convenience features.

Our transportation management systems business includes transportation engineering and consulting services focused on the planning, design, development and implementation of software-based systems that integrate sensors, video surveillance, computers and advanced communications equipment to enable public agencies to monitor, control and direct

traffic flow, assist in the quick dispatch of emergency crews and distribute real-time information about traffic conditions. Our services include planning, design and implementation of surface transportation infrastructure systems. We perform analysis and study goods movement, commercial vehicle operations, travel demand forecasting and systems engineering, and identify mitigation measures to reduce traffic congestion. These services and systems are primarily sold to local, state and national transportation agencies in the United States. Our transportation management systems business is largely dependent upon governmental funding and budgetary issues. The Federal Highway Bill that was passed in August 2005 provided for a significant increase in transportation funding over the following six years. We believe the recent expansion of our transportation management systems business was due in part to the passage of the Federal Highway Bill, combined with increased transportation funds available at state and local agencies throughout the country. The 2005 Federal Highway Bill is set to expire in 2009. It is too early to determine any impact on future contract revenues as a result of potential delays in the passage of future bills.

Prior to our fiscal year ended March 31, 2004 (Fiscal 2004), we operated in three segments consisting of ITS, video products and telecom products. The ITS segment consisted of our current operations, which was previously conducted by the Iteris Subsidiary. The video products segment included our former wholly-owned subsidiary, MAXxess Systems, Inc. (MAXxess), which designed and manufactured security management systems. Our telecom products segment included our wholly-owned subsidiary, Zyfer, Inc. (Zyfer), which developed and manufactured timing and synchronization products. During Fiscal 2004, we completed the divestiture of MAXxess and Zyfer and restructured our operations to focus on the operations of our Iteris Subsidiary. Our financial statements for all periods presented in this report have been restated to reflect the discontinuation of the operations of MAXxess and Zyfer.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition. We record product revenues and related costs of sales upon transfer of title, which is generally upon shipment or, if required, upon acceptance by the customer, provided that we believe collectibility of the net sales amount is reasonably assured. Accordingly, at the date revenue is recognized, the significant uncertainties concerning the sale have been resolved.

Contract revenues are derived primarily from long-term contracts with governmental agencies. Contract revenues include costs incurred plus a portion of estimated fees or profits determined using the percentage of completion method of accounting based on the relationship of costs

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incurred to total estimated costs. Any anticipated losses on contracts are charged to earnings when identified. Changes in job performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to recognized costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when their realization is reasonably assured.

In addition to product and contract revenues, we derive revenue from technology access fees, the provision of specific non-recurring contract engineering services to our strategic partner, Valeo, related to our AutoVue LDW systems, and royalties earned on unit sales of our AutoVue LDW systems by Valeo to the passenger car market. Technology access fee revenues are recognized evenly over the period in which they are earned. Non-recurring contract engineering revenues are

recognized in the period in which the related services are performed. Royalty revenues are recorded based on unit sales of our products by Valeo and are recognized in the period in which such sales occur. Technology access fee revenues, non-recurring contract engineering revenues and royalty revenues are included in net sales.

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

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

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

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

Warranty. We generally provide a one to three year warranty from the original invoice date on all products, materials and workmanship. Defective products are either repaired or replaced, at our option, upon meeting certain criteria. We accrue a provision for the estimated costs that may be incurred for product warranties relating to a product as a component of cost of sales at the time revenue for that product is recognized. The accrued warranty provision is included within accrued expenses on the accompanying consolidated balance sheets. Should our actual experience of warranty returns be higher than anticipated, additional warranty reserves may be required, which may adversely affect our operating results.

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

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

Effective April 1, 2007, we adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109* (FIN 48), which applies to all tax positions accounted for under Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes* (SFAS 109). FIN 48 clarifies the accounting for uncertainty in income taxes by establishing minimum standards for the recognition and measurement of tax positions taken or expected to be taken in a tax return. Under the requirements of

FIN 48, we must review all of our tax positions and make a determination as to whether our position is more-likely-than-not to be sustained upon examination by regulatory 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 ultimate settlement or disposition of the underlying issue.

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

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

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

Results of Operations

The following table sets forth certain statement of operations data as a percentage of total net sales and contract revenues for the periods indicated. The following table should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations.

| | Fiscal Year Ended March 31, | | |
|--|-----------------------------|--------|--------|
| | 2008 | 2007 | 2006 |
| Net sales and contract revenues: | | | |
| Net sales | 61.9% | 62.2% | 61.7% |
| Contract revenues | 38.1 | 37.8 | 38.3 |
| Total net sales and contract revenues | 100.0% | 100.0% | 100.0% |
| Costs of net sales and contract revenues: | | | |
| Cost of net sales (a) | 31.5 | 34.0 | 32.7 |
| Cost of contract revenues (a) | 25.1 | 24.8 | 24.9 |
| Gross profit | 43.4 | 41.2 | 42.4 |
| Operating expenses: | | | |
| Selling, general and administrative (a) | 26.5 | 27.4 | 30.5 |
| Research and development (a) | 5.5 | 6.9 | 10.3 |
| Amortization of intangible assets | 0.2 | 0.3 | 0.3 |
| Total operating expenses | 32.2 | 34.6 | 41.1 |
| Operating income | 11.2 | 6.6 | 1.2 |
| Non-operating income (expense): | | | |
| Other income (expense), net | 0.4 | (1.1) | 0.1 |
| Interest expense, net | (2.0) | (2.7) | (2.9) |
| Income (loss) before income taxes | 9.6 | 2.7 | (1.6) |
| Income tax benefit | 9.1 | 2.3 | 1.8 |
| Net income | 18.7% | 5.0% | 0.2% |

(a) Includes stock-based compensation expense as a percent of total net sales and contract revenues as follows:

| | | | |
|---|------|------|------|
| Cost of net sales | 0.0% | 0.0% | 0.1% |
| Cost of contract revenues | 0.0 | 0.1 | 0.4 |
| Selling, general and administrative expense | 0.4 | 0.3 | 0.7 |
| Research and development expense | 0.0 | 0.0 | 0.3 |
| Total stock-based compensation expense | 0.4% | 0.5% | 1.4% |

Analysis of Fiscal 2008, Fiscal 2007 and Fiscal 2006 Results of Operations

Net Sales and Contract Revenues. Net sales are comprised of Roadway Sensors sales, which are derived from sales of our Vantage video detection systems, and Vehicle Sensors sales, which are derived from sales of AutoVue LDW systems, technology access fees, contract engineering revenue and royalty revenue generated from AutoVue related activities. Contract revenues consist entirely of Transportation Systems contract revenues, which are generated from systems integration and ITS consulting services primarily with federal, state, county and municipal agencies. We currently have a diverse customer base with our largest customer constituting 7.3% of total net sales and contract revenues in

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Fiscal 2008. Total net sales and contract revenues increased 11.8% to \$65.2 million in Fiscal 2008 compared to \$58.3 million in Fiscal 2007, and increased 15.5% in Fiscal 2007 from \$50.5 million in Fiscal 2006.

Net sales increased 11.3% to \$40.3 million in Fiscal 2008 compared to \$36.2 million in Fiscal 2007, and increased 16.3% in Fiscal 2007 compared to \$31.2 million in Fiscal 2006. The increase in net sales in each of the periods reflected increased unit sales in both Roadway Sensors and Vehicle Sensors.

Roadway Sensors net sales comprised 70.6%, 75.2% and 72.0% of net sales in Fiscal 2008, Fiscal 2007 and Fiscal 2006, respectively, and increased 4.4% to \$28.5 million in Fiscal 2008 compared to \$27.3 million in Fiscal 2007 and increased 21.5% in Fiscal 2007 compared to \$22.4 million in Fiscal 2006. The majority of Roadway

Sensors net sales were derived from sales within North America. The Fiscal 2008 and Fiscal 2007 increases primarily reflect the continued adoption of video vehicle detection technology, such as the technology offered by our Vantage line of products, both domestically and internationally. Fiscal 2008 sales growth was not as strong as sales growth in Fiscal 2007 due primarily to lower sales volumes in Texas as a result of local budgetary issues, a trend that we expect to continue for at least the next few fiscal quarters. We continue to believe that the current increased rate of adoption has to some extent been due to increased government spending on traffic initiatives, which we believe has been at least partially made possible by the passage of the Federal Highway Bill in August 2005, as well as expanded sales and marketing efforts, particularly in North America. The 2005 Federal Highway Bill is set to expire in 2009. Although we are not aware of any imminent changes in government spending patterns, it is possible that, as a result of softening macroeconomic conditions in the U.S. and the decline in the new housing market, government funding for certain traffic initiatives and roadway improvement projects could be delayed or diverted to focus on other budgetary needs. Should this occur, future domestic Roadway Sensors net sales may be adversely affected.

Net sales from Vehicle Sensors products and services increased 32.1% in Fiscal 2008 to \$11.9 million compared to \$9.0 million in Fiscal 2007 and increased 3.2% in Fiscal 2007 compared to \$8.7 million in Fiscal 2006. The largest element of Vehicle Sensors net sales was sales of our LDW systems to the heavy truck market, which aggregated \$10.0 million in Fiscal 2008, \$6.4 million in Fiscal 2007 and \$5.9 million in Fiscal 2006. The increase in Fiscal 2008 net sales of Vehicle Sensors products was primarily a result of increased unit sales of our LDW systems to European and Asian OEMs. The increase in Fiscal 2007 net sales of Vehicle Sensors products was primarily related to increased unit sales of LDW systems in the North American commercial heavy truck market, partially offset by OEM volume discounts provided to our largest customer and the impact of the transition to our next generation AutoVue LDW systems for the heavy truck market in the latter part of Fiscal 2006.

Although we have experienced an overall increase in unit sales of our AutoVue LDW systems in recent fiscal years, in Fiscal 2008, we began to experience softness in LDW unit sales to the North American truck market as a result of an overall decline in new truck sales in the U.S. driven largely by the general slowdown in the U.S. housing market and overall economy. We expect flat or declining LDW unit sales in the North American market over at least the next several fiscal quarters due to these macroeconomic conditions. We have not experienced the same decline in net sales to our European and Asian OEM customers; however, a slowdown in international truck sales could lead to similar sluggishness in LDW unit sales internationally. Vehicle Sensors unit sales in Fiscal 2009 and beyond could also be adversely impacted by slower than expected adoption rates of our LDW system by European and Asian OEMs and North American heavy truck fleets, as well as potential additional OEM volume discounts resulting from increased price competition as new competitors have entered this market. Additionally, recent environmental regulations in Europe and North America have substantially increased the cost of new commercial trucks, which could impact future truck sales volumes and, ultimately, unit sales of our LDW systems.

Also included in Vehicle Sensors net sales are revenues from contract engineering services, technology access fees and royalty revenues in the passenger car market that are derived from our strategic relationship with Valeo, which aggregated \$1.9 million, \$2.6 million and \$2.8 million in Fiscal 2008, Fiscal 2007 and Fiscal 2006, respectively. Such revenues were lower in Fiscal 2008 as compared to Fiscal 2007 and Fiscal 2006 as a result of technology access fee revenue of \$500,000 that was recognized in Fiscal 2007 and Fiscal 2006. Royalty revenues from Valeo for sales of our LDW systems for the passenger car market were relatively insignificant in Fiscal 2008, Fiscal 2007 and Fiscal 2006. Our LDW systems are now offered as an option on three Infiniti models. While Valeo is currently in discussions to offer our LDW systems on other passenger car platforms, we cannot assure you that Valeo will be successful in these efforts.

Contract revenues increased 12.6% to \$24.8 million in Fiscal 2008 compared to \$22.0 million in Fiscal 2007 and increased 14.1% in Fiscal 2007 compared to \$19.3 million in Fiscal 2006. Contract revenues are dependent upon the continued availability of funding at both the state and federal levels from the various departments of transportation. The Fiscal 2008 and Fiscal 2007 increases in contract revenues were largely due to increased funding at the federal, state and local levels throughout the country, as well as new contract awards. In response to the growth in our Transportation Systems segment, we increased our Transportation Systems staff by 21% in Fiscal 2008 and 16% in Fiscal 2007. We expect to continue to increase our Transportation Systems staff in Fiscal 2009. We believe the ability of our Transportation Systems business to grow and successfully win and service new contracts will be highly dependent upon our continued success in recruiting and retaining qualified personnel. All of our contract revenues are derived from work performed in North America under a broad range of fixed price and cost plus fixed fee contracts.

Gross Profit. Total gross profit increased 17.9% to \$28.3 million in Fiscal 2008 compared to \$24.0 million in Fiscal 2007, and increased 12.2% in Fiscal 2007 compared to \$21.4 million in Fiscal 2006. Total gross profit as a percent of net sales and contract revenues increased to 43.4% in Fiscal 2008 compared to 41.2% in Fiscal 2007 and decreased in Fiscal 2007 from 42.4% in Fiscal 2006.

Gross profit as a percentage of net sales was 49.2% in Fiscal 2008 compared to 45.3% in Fiscal 2007 and 47.1% in Fiscal 2006. The increase in gross profit as a percentage of net sales in Fiscal 2008 was a result of a favorable sales mix in terms of both geography and product mix, as well as improved production efficiencies. Gross profit as a percentage of net sales also improved in Fiscal 2008 through the expansion of our Vehicle Sensors customer base, which helped mitigate the impact of lower contractual pricing to our largest European customer. The decrease in gross profit as a percentage of net sales in Fiscal 2007 compared to Fiscal 2006 was primarily due to volume discounts given to our largest Vehicle Sensors product customer, as well as an overall decline in unit volumes to this customer. Fiscal 2007 gross profit as a percentage of net sales in our Roadway Sensors division was relatively consistent with Fiscal 2006 gross profit as a percentage of net sales. Gross profit as a percentage of net sales can fluctuate in any specific quarter or year based on customer and product mix, as well as possible shifts of engineering resources from development activities to sustaining activities, which we record as cost of goods sold. Gross profit as a percent of net sales has fluctuated over the last five years from a low of 45.2% in Fiscal 2005 to a high of 49.2% in Fiscal 2008.

Gross profit as a percentage of contract revenues decreased to 34.1% in Fiscal 2008 compared to 34.4% in Fiscal 2007 and decreased from 34.8% in Fiscal 2006. We recognize contract revenues and related gross profit using percentage of completion contract accounting and the underlying mix of contract activity affects the related gross profit recognized in any given period. The decreases in gross profit as a percent of contract revenues in Fiscal 2008 compared to Fiscal 2007, and in Fiscal 2007 compared to Fiscal 2006 reflect a contract mix weighted more toward lower margin contracts in those periods. Lower margin contracts generally have a higher proportion of sub-consulting revenues associated with them.

Selling, General and Administrative Expense. Selling, general and administrative expense increased 8.0% to \$17.3 million (or 26.5% of total net sales and contract revenues) in Fiscal 2008 compared to \$16.0 million (or 27.4% of total net sales and contract revenues) in Fiscal 2007, and increased 3.8% in Fiscal 2007 compared to \$15.4 million (or 30.5% of total net sales and contract revenues) in Fiscal 2006. The increase in selling, general and administrative expense in Fiscal 2008 compared to Fiscal 2007 was largely attributable to higher commissions and selling expenses driven by sales growth in our Roadway Sensors segment, as well as general and administrative expenses incurred related to our efforts to comply with the internal control attestation requirements of the Sarbanes-Oxley Act. In Fiscal 2009, we expect to continue to experience increased selling, general and administrative expenses as we pursue further sales growth. Furthermore, we expect to experience further increases in general and administrative expenses as we continue our efforts to comply with the internal control attestation requirements of the Sarbanes-Oxley Act.

The increase in selling, general and administrative expense in Fiscal 2007 compared to Fiscal 2006 was mainly a result of higher commissions associated with increased Roadway Sensors net sales and increased sales and marketing activities in our Transportation Systems segment. Additionally, selling, general and administrative expense included legal expenses associated with the settlement of litigation described in Note 6 of Notes to Consolidated Financial Statements, a severance accrual of approximately \$300,000 associated with the departure of our former Chief Executive Officer in March 2007 and \$180,000 related to the write-off of past-due accounts receivable related to rent and other services provided to our former subsidiary, MAXxess (Note 6 of Notes to Consolidated Financial Statements). No further expense is expected to be incurred in connection with the aforementioned lawsuit or the severance arrangement with our former Chief Executive Officer. We have written off all balances receivable from MAXxess based on our accounts receivable accounting policy, but will continue to work with MAXxess to attempt to collect amounts due to us. Certain members of our Board of Directors are part of MAXxess management and ownership.

Research and Development Expense. Research and development expense decreased 11.5% to \$3.6 million (or 5.5% of total net sales and contract revenues) in Fiscal 2008 compared to \$4.0 million (or 6.9% of total net sales and contract revenues) in Fiscal 2007, and decreased 22.8% in Fiscal 2007 compared to \$5.2 million (or 10.3% of total net sales and contract revenues) in Fiscal 2006. The decrease in research and development expense in Fiscal 2008 compared to Fiscal 2007 was primarily due to reduced research and development activities in Vehicle Sensors as many of our significant truck OEM customers now have production LDW units that only require minimal further development and the majority of our passenger car research and development efforts are funded by our strategic partner, Valeo. This decreased spending was partially offset by increased research and development spending in Roadway Sensors. We believe research and development activities are crucial to our ability to continue to be a leader in our markets, and we expect our Fiscal 2009 research and development expenditures to increase from Fiscal 2008 levels.

The decrease in research and development expense in Fiscal 2007 compared to Fiscal 2006 was largely a result of higher than anticipated costs in Fiscal 2006 in Vehicle Sensors as we expended significant development resources in qualifying the next generation LDW system with our largest customer, as well as several other heavy truck OEMs. Additionally, in Fiscal 2007, there was a shift in engineering resources from research and development activities to product support activities as a result of new product introductions and improvements in Roadway Sensors. Costs associated with product support activities are included in cost of net sales rather than research and development expense.

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

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

| | 2008 | Year Ended March 31, 2007 | | 2006 |
|--------------------------------------|--------|------------------------------|-------|-------|
| | | (In thousands) | | |
| Gain on early extinguishment of debt | \$ 224 | \$ | | \$ |
| Settlement of lawsuits | | | (635) | |
| Other | 28 | | (18) | 35 |
| Other income (expense), net | \$ 252 | \$ | (653) | \$ 35 |

Other income (expense), net in Fiscal 2008 primarily reflects the gain of \$224,000 we recognized in connection with the early retirement of \$2.1 million of convertible debentures, which is discussed in Note 4 of Notes to Consolidated Financial Statements. Other income (expense), net in Fiscal 2007 primarily reflects \$635,000 of expense recorded in connection with the settlement of litigation in July 2006, which is discussed in Note 6 of Notes to Consolidated Financial Statements.

Interest Expense, Net. Interest expense, net reflects the net of interest expense and interest income as follows:

| | 2008 | Year Ended March 31, 2007 | | 2006 |
|-----------------------|------------|------------------------------|---------|------------|
| | | (In thousands) | | |
| Interest expense | \$ (1,285) | \$ | (1,601) | \$ (1,461) |
| Interest income | 1 | | 1 | 2 |
| Interest expense, net | \$ (1,284) | \$ | (1,600) | \$ (1,459) |

Interest expense, net decreased 19.8% in Fiscal 2008 compared to Fiscal 2007 and increased 9.7% in Fiscal 2007 compared to Fiscal 2006. The decrease in interest expense in Fiscal 2008 compared to Fiscal 2007 was primarily due to a lower level of borrowings as well as a lower interest rate on our line of credit, which bears interest at a rate indexed to the prime rate. The increase in interest expense in Fiscal 2007 compared to Fiscal 2006 was mainly related to the October 2006 refinancing of our bank term note and line of credit with a new bank, which resulted in a slightly higher interest rate on our bank borrowings.

Income Taxes. During Fiscal 2008, we recognized an income tax benefit of \$5.9 million and at March 31, 2008 our consolidated balance sheet included net deferred tax assets of \$10.3 million. The ability to record the deferred tax asset was based on the more likely than not criteria of SFAS No. 109, *Accounting for Income Taxes*. During Fiscal

2007, we recognized an income tax benefit of \$1.3 million and at March 31, 2007, our consolidated balance sheet included net deferred tax assets of \$3.0 million. The income tax benefits recorded in Fiscal 2008, Fiscal 2007 and Fiscal 2006 were primarily the result of a decrease in the valuation allowance recorded against our deferred tax assets as a result of changes in estimates of the future realizability of these assets. In the future, we may continue to record similar adjustments to our deferred tax asset valuation allowance as our estimates are updated. We anticipate this will cause our future overall effective tax rate in any given period to fluctuate from prior effective tax rates and statutory tax rates.

At March 31, 2008, we had \$44.7 million of federal net operating loss carryforwards and \$16.6 million of state net operating loss carryforwards that begin to expire in 2019 and 2013, respectively. Due to changes in stock ownership, our federal net operating loss carryforwards are subject to a Section 382 limitation estimated at approximately \$7.8 million annually which can be utilized to offset federal consolidated taxable income. Although the impact cannot be precisely determined, we believe that our net operating loss carryforwards and the valuation allowance we have recorded against our net deferred tax assets in our consolidated balance sheets will cause us to have future income tax payments and income tax expense that are substantially lower than the income tax liability and income tax expense calculated using statutory tax rates.

In Fiscal 2008, we adopted FIN 48. See Notes 1 and 5 of Notes to Consolidated Financial Statements for further discussion regarding our implementation of FIN 48.

Stock-Based Compensation Expense. In Fiscal 2007, we adopted SFAS 123R using the modified prospective approach. Stock-based compensation expense remained relatively consistent in Fiscal 2008 and Fiscal 2007 at \$290,000 and \$288,000, respectively. See Notes 1 and 9 of Notes to Consolidated Financial Statements for additional discussion regarding our implementation of SFAS 123R.

Liquidity and Capital Resources

Cash Flows

We have historically financed our operations with a combination of cash flows from operations, borrowings under credit facilities and the sale of equity securities. We currently rely on cash flows from operations and borrowings on a line of credit facility to fund our operations, which we believe to be sufficient to fund our operations for at least the next twelve months. At March 31, 2008, we had \$14.9 million in working capital, which included no borrowings on our \$10.0 million line of credit and \$421,000 in cash and cash equivalents, as compared to working capital of \$7.0 million at March 31, 2007, which included borrowings of \$4.0 million on our line of credit and \$35,000 in cash and cash equivalents. Our operations provided \$7.6 million of cash during Fiscal 2008, primarily as a result of net income adjusted for non-cash items within the statement of operations. During Fiscal 2007, our operations used \$2.0 million of cash, primarily as a result of investments in inventory due to sales growth and longer lead times in procuring certain components, and an increased level of net costs and estimated earnings in excess of billings due to sales growth and the timing of invoicing on contracts in our Transportation Systems segment. These were partially offset by net income of \$2.9 million. During Fiscal 2006, our operations provided \$218,000 of cash, primarily as a result of planned decreases in inventory and the timing of payments on accrued expenses and payables, which were partially offset by increases in accounts receivable and net costs and estimated earnings in excess of billings on uncompleted contracts, both as a result of sales growth.

Investing activities for Fiscal 2008, Fiscal 2007 and Fiscal 2006 consisted primarily of purchases of property and equipment, which aggregated \$739,000, \$488,000 and \$1.3 million, respectively. In Fiscal 2006, capital expenditures were higher primarily due to hardware, software and related labor costs to implement a new enterprise resource management system, which was placed in service at the beginning of Fiscal 2007.

Cash used in financing activities was \$6.5 million in Fiscal 2008, which was the net result of net payments on borrowings of \$8.0 million offset by cash inflows of \$1.5 million from the exercise of outstanding stock options and warrants to purchase our common stock. During Fiscal 2007, financing activities provided \$2.4 million of cash, which was the net result of net payments on borrowings of \$1.2 million, offset by cash inflows of \$3.6 million from the exercise of outstanding stock options and warrants to purchase our common stock. As discussed in Note 8 of Notes to Consolidated Financial Statements, approximately \$2.0 million of the \$3.6 million in proceeds from the exercise of stock options and warrants was raised through the exercise of outstanding warrants to purchase an aggregate of 1,250,000 shares of our common stock. During Fiscal 2006, financing activities provided \$1.1 million of cash as a result of net borrowings of \$792,000 and cash inflows of \$333,000 from the exercise of outstanding stock options and warrants to purchase our common stock.

Borrowings

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

| | At March 31, 2008 | |
|-----------------------------|--------------------------|-------|
| | (In thousands) | |
| Convertible debentures, net | \$ | 7,566 |
| Bank term note | | 210 |
| Other | | 34 |
| | \$ | 7,810 |

In October 2006, we entered into a two-year credit facility with a bank which includes our line of credit and bank term note. The credit facility provides for line of credit borrowings of up to \$10.0 million against our eligible accounts

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receivable and inventory, as defined in the credit agreement. The term note provided for monthly principal payments of approximately \$104,000 and matured in May 2008. The interest rate on the line of credit is the current stated prime rate plus 1.00%, and the interest rate on the bank term note was fixed at an annual rate of 8.75%. We are obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeds the average daily principal balance during the preceding month. The credit facility also requires \$2,000 in monthly collateral management fees and includes an early termination fee equal to 1% of the total facility. The credit facility is secured by substantially all of our assets. At March 31, 2008, we had \$8.6 million available under our credit facility, all of which was unused.

Contractual Obligations

Our contractual obligations were as follows at March 31, 2008:

| | Payments Due by Period | | | | | | | Total |
|------------------------|------------------------|----------|----------|----------|----------|------------|--|-----------|
| | 2009 | 2010 | 2011 | 2012 | 2013 | Thereafter | | |
| | (In thousands) | | | | | | | |
| Notes payable | \$ 244 | | | | | | | \$ 244 |
| Convertible debentures | | 7,750 | | | | | | 7,750 |
| Operating leases | 1,594 | 1,431 | 1,366 | 1,332 | 1,363 | 2,460 | | 9,546 |
| Total | \$ 1,838 | \$ 9,181 | \$ 1,366 | \$ 1,332 | \$ 1,363 | \$ 2,460 | | \$ 17,540 |

At March 31, 2008, we had firm commitments to purchase inventory in the amount of \$2.3 million during the first and second quarters of Fiscal 2009.

Off Balance Sheet Arrangements

In May 2004, we issued subordinated convertible debentures in an aggregate original principal amount of \$10.1 million. These debentures are due in full on May 19, 2009 and are convertible into shares of our common stock at a conversion price of \$3.61 per share. At March 31, 2008, convertible debentures in an aggregate principal amount of \$7.8 million remained outstanding. Because these debentures are conventionally convertible, we have not separately accounted for the conversion feature and, accordingly, no separate amounts are presented in our consolidated financial statements in connection with this conversion feature.

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

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

therewith. As of the date of this filing, no liquidated damages are payable under the provisions of the registration rights agreement associated with these warrants.

Recent Accounting Pronouncements

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In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008 the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for non-financial assets and liabilities to fiscal years beginning after November 15, 2008. Generally, this statement will be applied prospectively. We are currently evaluating the impact of SFAS 157 and expect to adopt SFAS 157 in the first quarter of our fiscal year ending March 31, 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are evaluating the impact that the adoption of SFAS 159 will have on our results of operations and financial condition and expect to adopt SFAS 159 in our fiscal year ending March 31, 2009.

Seasonality

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk is limited to our line of credit. Our line of credit bears interest based on the prevailing prime rate (5.25% at March 31, 2008). We do not believe that a 10% increase in the interest rate on our line of credit (from 6.25% to 6.88%) would have a material impact on our financial position, operating results or cash flows. In addition, we believe that the carrying value of our outstanding debt approximates fair value.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and supplementary data required by Regulation S-X are included in Part IV, Item 15 of this report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A(T). CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934, as of the end of the period covered by this Annual Report on Form 10-K, the Company's management evaluated,

with the participation of the Company's President and Chief Executive Officer and the Chief Financial Officer, the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the President and Chief Executive Officer and the Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in the Company's Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including the Company's President and Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

(b) Changes in internal control. There was no change in the Company's internal control over financial reporting that occurred during the period covered by this Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to management and the board of directors regarding the effectiveness of our internal control processes over the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We have assessed the effectiveness of our internal controls over financial reporting as of March 31, 2008. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on our assessment, we believe that, as of March 31, 2008, our internal control over financial reporting is effective based on those criteria.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to the rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

ITEM 9B. OTHER INFORMATION

On June 11, 2008, we entered into a change in control agreement with James Miele, our Chief Financial Officer. Pursuant to the terms of the agreement, in the event of an Involuntary Termination (as defined in the agreement) of Mr. Miele's employment in connection with or within twelve months after a change in control, Mr. Miele will be entitled to receive a lump sum severance payment of up to one year's base pay and 50% of his target bonus for the year. In addition, Mr. Miele will be entitled to receive reimbursement for the cost of COBRA coverage for a period of up to one year following the termination of his employment. The agreement terminates on the fifth anniversary of the date of the agreement, unless earlier terminated in accordance therewith.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

(a) *Identification of Directors.* The information under the caption "Election of Directors," appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

(b) *Identification of Executive Officers.* The information under the caption "Executive Compensation and Other Information - Executive Officers," appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

(c) *Compliance with Section 16(a) of the Exchange Act.* The information under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" appearing in our proxy statement for the 2008 Annual Meeting of Stockholders is incorporated herein by reference.

(d) *Corporate Governance.* The information under the caption "Corporate Governance," appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

(e) *Audit Committee*. The information under the caption Board Meetings and Committees Audit Committee, appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information under the caption Executive Compensation and Other Information, appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information under the captions Equity Compensation Plans and Principal Stockholders and Common Stock Ownership of Certain Beneficial Owners and Management, appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information under the captions Corporate Governance Director Independence and Certain Transactions, appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information under the caption Fees Paid to Independent Registered Public Accounting Firm, appearing in our proxy statement for the 2008 Annual Meeting of Stockholders, is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this report:

1. *Financial Statements.* The following financial statements of Iteris, Inc. are included in a separate section of this Annual Report on Form 10-K commencing on the pages referenced below:

| | |
|---|----|
| <u>Report of Independent Registered Public Accounting Firm</u> | 40 |
| <u>Consolidated Balance Sheets as of March 31, 2008 and 2007</u> | 41 |
| <u>Consolidated Statements of Operations for the years ended March 31, 2008, 2007 and 2006</u> | 43 |
| <u>Consolidated Statements of Stockholders' Equity and Comprehensive Income for the years ended March 31, 2008, 2007 and 2006</u> | 44 |
| <u>Consolidated Statements of Cash Flows for the years ended March 31, 2008, 2007 and 2006</u> | 45 |
| <u>Notes to Consolidated Financial Statements</u> | 46 |

2. *Financial Statement Schedules.*

| | |
|--|----|
| <u>Schedule II Valuation and Qualifying Accounts</u> | 63 |
|--|----|

All other schedules have been omitted because they are not required or the required information is included in our consolidated financial statements and notes thereto.

3. *Exhibits.*

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

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| Exhibit Number | Description | Where Located |
|-----------------------|--|--|
| 3.1 | Amended and Restated Certificate of Incorporation of the registrant | <i>Exhibit 3.1 to the registrant's Current Report on Form 8-K as filed with the SEC on October 28, 2004</i> |
| 3.2 | Certificate of Amendment to Amended and Restated Certificate of Incorporation effective September 26, 2007 | <i>Exhibit 3.2 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 as filed with the SEC on November 13, 2007</i> |
| 3.3 | Bylaws of the registrant, as amended | <i>Exhibit 4.2 to the registrant's Registration Statement on Form S-1 (Reg. No. 033-67932) as filed with the SEC on July 6, 1993</i> |
| 3.4 | Certificates of Amendment to Bylaws of the registrant dated April 24, 1998 and August 10, 2001 | <i>Exhibit 3.4 to the registrant's Annual Report on Form 10-K/A for the year ended March 31, 2003 as filed with the SEC on July 29, 2003</i> |
| 3.5 | Certificate of Amendment to Bylaws of registrant dated September 9, 2004 | <i>Exhibit 3.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 as filed with the SEC on November 15, 2004</i> |

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| Exhibit Number | Description | Where Located |
|----------------|--|--|
| 3.6 | Certificate of Amendment to Bylaws of registrant effective September 16, 2005 | <i>Exhibit 3.5 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2007</i> |
| 3.7 | Certificate of Amendment to Bylaws of registrant effective December 7, 2007 | <i>Exhibit 3.1 to the registrant's Current Report on Form 8-K as filed with the SEC on December 13, 2007</i> |
| 4.1 | Specimen of common stock certificate | <i>Exhibit 4.1 to registrant's Registration Statement on Form 8-A as filed with the SEC on December 8, 2004</i> |
| 4.2 | Amended and Restated Rights Agreement, dated as of May 10, 2004, by and between the registrant and U.S. Stock Transfer Corporation, including exhibits thereto | <i>Exhibit 99.1 to the registrant's Registration Statement on Form 8-A/A as filed with the SEC on June 18, 2004</i> |
| 10.1* | Profit Sharing Plan and Trust | <i>Exhibit 10.3 to the registrant's Amendment No. 2 to the Registration Statement on Form S-8 (Reg. No. 002-98656) as filed with the SEC on May 5, 1988</i> |
| 10.2* | Amendment Nos. 3 and 4 to the Profit Sharing Plan and Trust | <i>Exhibits 4.3.1 and 4.3.2, respectively, to Amendment No. 3 to the registrant's Registration Statement on Form S-3 (Reg. No. 002-86220) as filed with the SEC on June 13, 1990</i> |
| 10.3* | Form of Executive Deferral Plan between the registrant and certain employees of the registrant | <i>Exhibit 10.4 to the registrant's Annual Report on Form 10-K for the year ended March 31, 1988</i> |
| 10.4 | Form of Indemnity Agreement entered into by the registrant and certain of its officers and directors | <i>Exhibit 19.4 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1988</i> |
| 10.5 | Form of Indemnification Agreement entered into by the registrant and certain of its officers and directors | <i>Exhibit 10.5 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2004 as filed with the SEC on June 29, 2004</i> |
| 10.6* | 1997 Stock Incentive Plan (as amended on May 3, 2003, as further amended on December 15, 2004) | <i>Exhibit 10.32 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2005 as filed with the SEC on July 14, 2005</i> |
| 10.7* | Form of Notice of Grant of Stock Option | <i>Exhibit 99.2 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.8* | Form of Stock Option Agreement | <i>Exhibit 99.3 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.9* | Form of Addendum to Stock Option Agreement Involuntary Termination Following Corporate Transaction or Change in Control | <i>Exhibit 99.4 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.10* | Form of Addendum to Stock Option Agreement Limited Stock Appreciation Rights | <i>Exhibit 99.5 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |

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| Exhibit Number | Description | Where Located |
|----------------|--|--|
| 10.11* | Form of Stock Issuance Agreement | <i>Exhibit 99.6 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.12* | Form of Addendum to Stock Issuance Agreement Involuntary Termination Following Corporate Transaction/Change in Control | <i>Exhibit 99.7 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.13* | Form of Notice of Grant of Automatic Stock Option Initial Grant | <i>Exhibit 99.8 to Exhibit 99.8 to registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.14* | Form of Notice of Grant of Automatic Stock Option Annual Grant | <i>Exhibit 99.9 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i> |
| 10.15* | Form of Automatic Stock Option Agreement. | <i>Exhibit 99.10 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 19, 2000</i> |
| 10.16 | Amended and Restated Agreement of Purchase and Sale and Escrow Instructions, dated February 19, 2002, by and between Iteris, Inc. and 1515 South Manchester, LLC | <i>Exhibit 2.1 to the registrant's Current Report on Form 8-K as filed with the SEC on June 12, 2002</i> |
| 10.17* | Change in Control Agreement dated May 8, 2003 by and between the registrant and Gregory A. Miner | <i>Exhibit 10.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 as filed with the SEC on August 14, 2003</i> |
| 10.18* | Change in Control Agreement dated May 20, 2003 by and between the registrant and Jack E. Johnson | <i>Exhibit 10.23 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 as filed with the SEC on February 17, 2004</i> |
| 10.19* | Iteris Inc. 1998 Stock Incentive Plan (as amended on February 7, 2000) | <i>Exhibit 10.24 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2005 as filed with the SEC on July 14, 2005</i> |
| 10.20* | Form of Notice of Grant, including forms of Option Agreement and Stock Purchase Agreement for the following directors and executive officers: Gary Hernandez, Dr. Hartmut Marwitz, Paul E. Wright, Jack Johnson, Richard D. Crawshaw, Gregory McKhann, Francis Memole, James S. Miele, Abbas Mohaddes and Stephen Edwin Rowe | <i>Exhibit 99.2 to the registrant's Registration Statement on Form S-8 (File No. 333-126834) as filed with the SEC on July 22, 2005</i> |
| 10.21* | Form of Addendum to Stock Option Agreement | <i>Exhibit 99.3 to the registrant's Registration Statement on Form S-8 (File No. 333-126834) as filed with the SEC on July 22, 2005</i> |
| 10.22* | Form of 1997 Stock Option Agreements | <i>Exhibit 99.4 to the registrant's Registration Statement on Form S-8 (File No. 333-126834) as filed with the SEC on July 22, 2005</i> |
| 10.23* | Iteris, Inc. Deferred Compensation Savings Plan and Grantor Trust | <i>Exhibit 10.31 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2005 as filed with the SEC on July 14, 2005</i> |

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| Exhibit Number | Description | Where Located |
|----------------|---|--|
| 10.24+ | Cooperative Agreement for Development, Manufacture, Marketing and Sale of Products to the Class 1 and Class 2 Vehicle Markets Incorporating Iteris LDWS Technology (Valeo Schalter and Sensoren GmbH) | <i>Exhibit 10.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 as filed with the SEC on August 16, 2004</i> |
| 10.25 | Warrant Exercise Agreement dated September 27, 2006 by and among the registrant and Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P. | <i>Exhibit 10.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |
| 10.26 | Registration Rights Agreement dated September 28, 2006 by and among the registrant and Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P. | <i>Exhibit 10.2 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |
| 10.27+ | National Intelligent Transportation Systems (ITS) Architecture Evolution and Support Award/Contract effective as of October 1, 2006 by and between the registrant and the Federal Highway Administration | <i>Exhibit 10.3 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |
| 10.28 | Loan and Security Agreement effective as of October 16, 2006 by and between the registrant and Silicon Valley Bank | <i>Exhibit 10.4 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |
| 10.29 | Intellectual Property Security Agreement dated October 9, 2006 by and between the registrant and Silicon Valley Bank | <i>Exhibit 10.5 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |
| 10.30+ | Settlement Agreement, effective August 15, 2006, by and between the registrant and Delta Networks, Inc. | <i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on August 21, 2006</i> |
| 10.31* | Offer letter effective February 28, 2007 by and between the registrant and Abbas Mohaddes | <i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on March 6, 2007</i> |
| 10.32* | Separation Agreement and Release of Claims dated March 1, 2007 by and between the registrant and Jack Johnson | <i>Exhibit 10.2 to the registrant's Current Report on Form 8-K as filed with the SEC on March 6, 2007</i> |
| 10.33 | Sublease Agreement, dated September 30, 2003, by and between Odetics, Inc. and Maij, Inc. | <i>Exhibit 10.1 to the registrant's Quarterly Report on Form 10-Q as filed with the SEC on August 14, 2007</i> |
| 10.34 | Office Lease Agreement, dated May 24, 2007, by and between Crown Carnegie Associates, LLC and Iteris, Inc. | <i>Exhibit 10.2 to the registrant's Quarterly Report on Form 10-Q as filed with the SEC on August 14, 2007</i> |
| 10.35 | Termination Agreement, dated May 30, 2007, by and among Transportation Planning Group, Inc., Abbas Mohaddes and Iteris, Inc. | <i>Exhibit 10.3 to the registrant's Quarterly Report on Form 10-Q as filed with the SEC on August 14, 2007</i> |

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| Exhibit Number | Description | Where Located |
|----------------|---|---|
| 10.36* | 2007 Omnibus Incentive Plan and forms of agreements | <i>Appendix A to the registrant's Definitive Proxy Statement on Schedule 14A as filed with the SEC on August 10, 2007</i> |
| 10.37 | Amendment to Loan and Security Agreement, dated October 17, 2007, by and between Silicon Valley Bank and Iteris, Inc. | <i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on October 23, 2007</i> |
| 10.38 | Debenture Redemption Agreement, dated February 11, 2008, by and among Potomac Capital Partners, LP, Potomac Capital International Ltd. and Iteris, Inc. | <i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on February 15, 2008</i> |
| 10.39 | Debenture Redemption Agreement, dated February 27, 2008, by and between Gruber & McBaine International and Iteris, Inc. | <i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on February 29, 2008</i> |
| 10.40 | Debenture Redemption Agreement, dated February 27, 2008, by and between Lagunitas Partners, LP and Iteris, Inc. | <i>Exhibit 10.2 to the registrant's Current Report on Form 8-K as filed with the SEC on February 29, 2008</i> |
| 10.41 | Debenture Redemption Agreement, dated February 27, 2008, by and between Jon D. and Linda W. Gruber Trust and Iteris, Inc. | <i>Exhibit 10.3 to the registrant's Current Report on Form 8-K as filed with the SEC on February 29, 2008</i> |
| 10.42* | Change in Control Agreement dated June 11, 2008 by and between James S. Miele and Iteris, Inc. | <i>Filed Herewith</i> |
| 21 | Subsidiaries of the registrant | <i>Filed Herewith</i> |
| 23 | Consent of Independent Registered Public Accounting Firm | <i>Filed Herewith</i> |
| 31.1 | Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed Herewith</i> |
| 31.2 | Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed Herewith</i> |
| 32.1 | Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | <i>Filed Herewith</i> |
| 32.2 | Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | <i>Filed Herewith</i> |

* Indicates a management contract or compensatory plan or arrangement

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

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

ITERIS, INC.
(Registrant)

By

/s/ ABBAS MOHADDES
Abbas Mohaddes
President and Chief Executive Officer

POWER OF ATTORNEY

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We, the undersigned officers and directors of Iteris, Inc., do hereby constitute and appoint James S. Miele and Abbas Mohaddes, and each of them, our true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby, ratifying and confirming all that each of said attorneys-in-fact and agents, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated:

| Signature | Title | Date |
|---|--|---------------|
| /s/ ABBAS MOHADDES Abbas Mohaddes | Director, President and Chief Executive Officer (principal executive officer) | June 11, 2008 |
| /s/ JAMES S. MIELE James S. Miele | Chief Financial Officer (principal financial and accounting officer) | June 11, 2008 |
| /s/ GREGORY A. MINER Gregory A. Miner | Chairman of the Board | June 11, 2008 |
| /s/ RICHARD CHAR Richard Char | Director | June 11, 2008 |
| /s/ KEVIN C. DALY Kevin C. Daly, Ph.D. | Director | June 11, 2008 |
| /s/ JOHN SEAZHOLTZ John Seazholtz | Director | June 11, 2008 |
| /s/ JOEL SLUTZKY Joel Slutzky | Director | June 11, 2008 |
| /s/ THOMAS L. THOMAS Thomas L. Thomas | Director | June 11, 2008 |

Iteris, Inc.

Index to Consolidated Financial Statements

| | |
|--|----|
| <u>Report of Independent Registered Public Accounting Firm</u> | 40 |
| <u>Consolidated Balance Sheets as of March 31, 2008 and 2007</u> | 41 |
| <u>Consolidated Statements of Operations for the years ended March 31, 2008, 2007, and 2006</u> | 43 |
| <u>Consolidated Statements of Stockholders' Equity and Comprehensive Income for the years ended March 31, 2008, 2007, and 2006</u> | 44 |
| <u>Consolidated Statements of Cash Flows for the years ended March 31, 2008, 2007, and 2006</u> | 45 |
| <u>Notes to Consolidated Financial Statements</u> | 46 |

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders

Iteris, Inc.

We have audited the consolidated balance sheets of Iteris, Inc. as of March 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity and comprehensive income and cash flows for each of the three years in the period ended March 31, 2008. Our audits also included the financial statement schedules of Iteris, Inc. listed in Item 15(a). These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Iteris, Inc. as of March 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2008, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective April 1, 2007 the Company changed its method of accounting for uncertainty in income taxes, and effective April 1, 2006 the Company changed its method of accounting for stock-based compensation.

We were not engaged to examine management's assertion about the effectiveness of Iteris, Inc.'s internal control over financial reporting as of March 31, 2008 included in the accompanying Management's Report On Internal Control Over Financial Reporting and, accordingly, we do not express an opinion thereon.

/s/ McGladrey & Pullen, LLP
Irvine, California
June 11, 2008

Iteris, Inc.

Consolidated Balance Sheets

(In thousands)

| | 2008 | March 31, | 2007 |
|---|-----------|-----------|-----------|
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 421 | | \$ 35 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$1,020 and \$664 at March 31, 2008 and 2007, respectively | 13,108 | | 11,493 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 5,351 | | 3,689 |
| Deferred income taxes | 2,541 | | 494 |
| Inventories, net of reserve for inventory obsolescence of \$819 and \$844 at March 31, 2008 and 2007, respectively | 4,226 | | 6,379 |
| Prepaid expenses and other current assets | 371 | | 385 |
| Total current assets | 26,018 | | 22,475 |
| Property and equipment: | | | |
| Leasehold improvements | 1,915 | | 112 |
| Equipment | 7,356 | | 6,830 |
| Accumulated depreciation | (5,804) | | (5,230) |
| | 3,467 | | 1,712 |
| Deferred income taxes | 7,807 | | 2,533 |
| Intangible assets, net of accumulated amortization of \$555 and \$408 at March 31, 2008 and 2007, respectively | 257 | | 404 |
| Goodwill | 27,774 | | 27,774 |
| Other assets | 322 | | 352 |
| Total assets | \$ 65,645 | | \$ 55,250 |

See accompanying notes.

Iteris, Inc.

Consolidated Balance Sheets

(In thousands, except per share amounts)

| | 2008 | March 31, | 2007 |
|---|---|-----------|-----------|
| Liabilities and stockholders' equity | | | |
| Current liabilities: | | | |
| Trade accounts payable | \$ 3,902 | \$ | 3,542 |
| Accrued payroll and related expenses | 3,825 | | 3,527 |
| Accrued liabilities | 1,973 | | 1,618 |
| Revolving line of credit | | | 4,015 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 1,126 | | 847 |
| Current portion of long-term debt | 244 | | 1,947 |
| Total current liabilities | 11,070 | | 15,496 |
| Deferred rent | 1,956 | | |
| Unrecognized tax benefits | 1,381 | | |
| Deferred compensation plan liability | 391 | | 730 |
| Other non-current liabilities | 70 | | 163 |
| Long-term debt | 7,566 | | 9,760 |
| Commitments and contingencies | | | |
| Redeemable common stock | | | |
| Issued and outstanding shares | none at March 31, 2008 and 1,219 at March 31, 2007 | | 3,414 |
| Stockholders' equity: | | | |
| Preferred stock, \$1.00 par value: | | | |
| Authorized shares | 2,000 | | |
| Issued and outstanding shares | none | | |
| Common stock, \$.10 par value: | | | |
| Authorized shares | 70,000 at March 31, 2008 and 50,000 at March 31, 2007 | | |
| Issued and outstanding shares | 33,420 at March 31, 2008 and 30,601 at March 31, 2007 | | 3,060 |
| Additional paid-in capital | 135,516 | | 130,425 |
| Common stock held in trust | 167 shares at March 31, 2008 and 311 shares at March 31, 2007 | | |
| | (202) | | (374) |
| Notes receivable from employees | | | (5) |
| Accumulated deficit | (95,499) | | (107,438) |
| Accumulated other comprehensive income | 54 | | 19 |
| Total stockholders' equity | 43,211 | | 25,687 |
| Total liabilities and stockholders' equity | \$ 65,645 | \$ | 55,250 |

See accompanying notes.

Iteris, Inc.

Consolidated Statements of Operations

(In thousands, except per share amounts)

| | Year Ended March 31, | | |
|---|----------------------|-----------|-----------|
| | 2008 | 2007 | 2006 |
| Net sales and contract revenues: | | | |
| Net sales | \$ 40,326 | \$ 36,248 | \$ 31,156 |
| Contract revenues | 24,837 | 22,049 | 19,330 |
| Total net sales and contract revenues | 65,163 | 58,297 | 50,486 |
| Costs of net sales and contract revenues: | | | |
| Cost of net sales (a) | 20,499 | 19,829 | 16,493 |
| Cost of contract revenues (a) | 16,367 | 14,460 | 12,600 |
| Gross profit | 28,297 | 24,008 | 21,393 |
| Operating expenses: | | | |
| Selling, general and administrative (a) | 17,289 | 16,003 | 15,410 |
| Research and development (a) | 3,566 | 4,030 | 5,217 |
| Amortization of intangible assets | 147 | 147 | 147 |
| Total operating expenses | 21,002 | 20,180 | 20,774 |
| Operating income | 7,295 | 3,828 | 619 |
| Non-operating income (expense): | | | |
| Other income (expense), net | 252 | (653) | 35 |
| Interest expense, net | (1,284) | (1,600) | (1,459) |
| Income (loss) before income taxes | 6,263 | 1,575 | (805) |
| Income tax benefit | 5,900 | 1,343 | 885 |
| Net income | \$ 12,163 | \$ 2,918 | \$ 80 |
| Earnings per share: | | | |
| Basic | \$ 0.37 | \$ 0.10 | \$ 0.00 |
| Diluted | \$ 0.35 | \$ 0.09 | \$ 0.00 |
| Weighted average shares outstanding: | | | |
| Basic | 32,723 | 29,698 | 28,182 |
| Diluted | 34,713 | 33,348 | 32,737 |

(a) Includes stock-based compensation expense as follows:

| | | | |
|---|--------|--------|--------|
| Cost of net sales | \$ 3 | \$ 13 | \$ 27 |
| Cost of contract revenues | 14 | 60 | 205 |
| Selling, general and administrative expense | 266 | 195 | 364 |
| Research and development expense | 7 | 20 | 129 |
| Total stock-based compensation expense | \$ 290 | \$ 288 | \$ 725 |

See accompanying notes.

Iteris, Inc.

Consolidated Statements of Stockholders Equity and Comprehensive Income

(In thousands)

| | Common Stock Shares Outstanding | Amount | Additional Paid-In Capital | Common Stock Held in Trust | Treasury Stock | Notes Receivable From Employees | Accumulated Deficit | Accumulated Other Comprehensive Income | Total Stockholder Equity | Comprehensive Income |
|---|--|----------|----------------------------------|-------------------------------------|-------------------|--|------------------------|---|--------------------------------|-------------------------|
| Balance at March 31, 2005 | 27,090 | \$ 2,709 | \$ 125,609 | \$ (374) | | (1) | \$ (45) | \$ (110,436) | \$ 17,462 | |
| Warrant exercises | 98 | 9 | 28 | | | | | | 37 | |
| Stock option exercises | 244 | 25 | 275 | | | | (4) | | 296 | |
| Issuance of warrants | | | 28 | | | | | | 28 | |
| Stock-based compensation | | | 725 | | | | | | 725 | |
| Retirement of treasury stock | | | (1) | | 1 | | | | | |
| Foreign currency translation | | | | | | | | 7 | 7 | \$ 7 |
| Net income | | | | | | | 80 | | 80 | 80 |
| Balance at March 31, 2006 | 27,432 | 2,743 | 126,664 | (374) | | (49) | (110,356) | 7 | 18,635 | \$ 87 |
| Warrant exercises | 1,706 | 170 | 2,265 | | | | | | 2,435 | |
| Stock option exercises | 1,374 | 138 | 982 | | | | | | 1,120 | |
| Issuance of warrants | | | 22 | | | | | | 22 | |
| Stock-based compensation | | | 288 | | | | | | 288 | |
| Issuance of common stock in connection with legal settlement | 89 | 9 | 204 | | | | | | 213 | |
| Repayment of notes receivable from employees | | | | | | 44 | | | 44 | |
| Foreign currency translation | | | | | | | | 12 | 12 | \$ 12 |
| Net income | | | | | | | 2,918 | | 2,918 | 2,918 |
| Balance at March 31, 2007 | 30,601 | 3,060 | 130,425 | (374) | | (5) | (107,438) | 19 | 25,687 | \$ 2,930 |
| Conversion of redeemable common stock to common stock | 1,219 | 122 | 3,292 | | | | | | 3,414 | |
| Stock option exercises | 1,515 | 151 | 1,223 | | | | | | 1,374 | |
| Warrant exercises | 85 | 9 | 113 | | | | | | 122 | |
| Stock-based compensation | | | 290 | | | | | | 290 | |
| Issuance of shares held in trust | | | 178 | 172 | | | | | 350 | |

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| | | | | | | | | | | |
|--|-----------|----------|------------|----------|----|--------|-------------|--------|-----------|--------|
| Write-off of notes receivable from employees | | | (5) | | 5 | | | | | |
| Cumulative effect of adoption of FIN 48 | | | | | | (224) | | (224) | | |
| Foreign currency translation | | | | | | | 35 | 35 \$ | 35 | |
| Net income | | | | | | 12,163 | | 12,163 | 12,163 | |
| Balance at March 31, 2008 | 33,420 \$ | 3,342 \$ | 135,516 \$ | (202) \$ | \$ | \$ | (95,499) \$ | 54 \$ | 43,211 \$ | 12,198 |

See accompanying notes.

Iteris, Inc.

Consolidated Statements of Cash Flows

(In thousands)

| | Year Ended March 31, | | |
|---|----------------------|----------|----------|
| | 2008 | 2007 | 2006 |
| Operating activities | | | |
| Net income | \$ 12,163 | \$ 2,918 | \$ 80 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Change in deferred tax assets | (7,321) | (1,419) | (948) |
| Depreciation of property and equipment | 756 | 559 | 684 |
| Stock-based compensation | 290 | 288 | 725 |
| Gain on early extinguishment of debt | (224) | | |
| Amortization of debt discounts | 201 | 207 | 207 |
| Amortization of deferred financing costs | 135 | 137 | 138 |
| Amortization of deferred gain on sale-leaseback | (165) | (284) | (284) |
| Amortization of intangible assets | 147 | 147 | 147 |
| Issuance of common stock in connection with legal settlement | | 213 | |
| Fair value of warrants issued for services | | 22 | |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (1,615) | (67) | (2,560) |
| Net costs and estimated earnings in excess of billings | (1,383) | (1,042) | (658) |
| Inventories | 2,153 | (3,565) | 1,530 |
| Prepaid expenses and other assets | (77) | 19 | 109 |
| Accounts payable and accrued expenses | 2,519 | (182) | 1,048 |
| Net cash provided by (used in) operating activities | 7,579 | (2,049) | 218 |
| Investing activities | | | |
| Purchases of property and equipment | (739) | (488) | (1,258) |
| Financing activities | | | |
| (Payments on) proceeds from borrowings on lines of credit, net | (4,015) | 1,353 | 1,717 |
| Payments on long-term debt | (3,838) | (1,843) | (1,314) |
| Credit facility commitment fees | (50) | (40) | |
| Checks drawn in excess of available bank balances | (47) | (628) | 389 |
| Proceeds from stock option and warrant exercises | 1,496 | 3,555 | 333 |
| Proceeds from notes receivable from employees | | 44 | |
| Net cash provided by (used in) financing activities | (6,454) | 2,441 | 1,125 |
| Increase (decrease) in cash | 386 | (96) | 85 |
| Cash and cash equivalents at beginning of year | 35 | 131 | 46 |
| Cash and cash equivalents at end of year | \$ 421 | \$ 35 | \$ 131 |
| Supplemental cash flow information: | | | |
| Cash paid (received) during the period: | | | |
| Interest | \$ 1,008 | \$ 1,263 | \$ 1,095 |
| Income taxes | 24 | 39 | (2) |

Supplemental schedule of non-cash investing and financing activities:

| | | | | |
|--|----|-------|----|-----|
| Conversion of redeemable common stock to common stock | \$ | 3,414 | \$ | \$ |
| Lease incentives in connection with new headquarters lease | | 1,772 | | |
| Fair value of common stock issued in settlement of liabilities | | 350 | | |
| Write-off of notes receivable from employees | | (5) | | |
| Property and equipment financing | | | | 127 |
| Fair value of warrants issued in settlement of liabilities | | | | 28 |
| Exercises of stock options via notes receivable from employees | | | | 4 |
| Retirement of treasury stock | | | | 1 |

See accompanying notes.

Iteris, Inc.
Notes to Consolidated Financial Statements
March 31, 2008

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Iteris, Inc. (the Company) is a leader in the traffic management market and focuses on the development and application of advanced technologies that reduce traffic congestion, minimize the environmental impact of traffic congestion and improve the safety of surface transportation systems. By combining outdoor image processing, traffic engineering and information technology, the Company offers a broad range of Intelligent Transportation Systems and driver safety solutions to customers worldwide. The Company was originally incorporated in Delaware in 1987. In October 2004, the Company completed a merger with its majority-owned subsidiary, Iteris, Inc. (the Iteris Subsidiary), and officially changed its corporate name to Iteris, Inc.

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires 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, deferred tax assets, inventory and warranty reserves, costs to complete long-term contracts, overhead rates used in cost-plus contracts, contract reserves, the valuation of equity instruments and estimates of future cash flows used to assess the recoverability of long-lived assets and the realization of goodwill.

Reclassifications

Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

Revenue Recognition

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

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

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

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

Concentration of Credit Risk

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

At March 31, 2008 and 2007, accounts receivable from governmental agencies and prime government contractors were approximately \$6.4 million and \$5.2 million, respectively. No customer or government agency had a receivable balance at March 31, 2008 or 2007 greater than 10% of our total net sales and contract revenues for the years ended March 31, 2008 and 2007.

Fair Values of Financial Instruments

The fair value of cash and cash equivalents, receivables, inventories, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity. The fair value of line of credit agreements and long-term debt approximate carrying value because the related rates of interest approximate current market rates. The fair value of convertible debentures approximates carrying value because the effective interest rate, taking into account recorded debt discounts, approximates current market rates. At March 31, 2007, the fair value of redeemable common stock was \$2.8 million, based on the closing price of the Company's common stock on that date.

Cash and Cash Equivalents

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

Inventories

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

Property and Equipment

Property and equipment are recorded at cost and are depreciated over the estimated useful life ranging from three to eight years. Leasehold improvements are depreciated over the term of the related lease or the estimated useful life of the improvement, whichever is shorter. Beginning April 1, 2006, the Company began depreciating property and equipment using the straight-line method of depreciation, which the Company believes more closely approximates the usage of the underlying assets, which generally provide value evenly throughout the estimated life. Prior to this date, the Company used the double declining balance method of depreciation. As a result of this change in estimate, depreciation expense declined by \$455,000 for the year ended March 31, 2007, resulting in a \$0.02 per share impact on basic and diluted earnings per share.

Goodwill and Long-Lived Assets

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

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

Income Taxes

The Company utilizes the liability method of accounting for income taxes as set forth in SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities using enacted tax rates. A valuation allowance is recorded when it is more likely than not that all or a portion of the deferred tax assets will not be realized. See Note 5.

On April 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by establishing minimum standards for the recognition and measurement of tax positions taken or expected to be taken in a tax return. Under the requirements of FIN 48, the Company must review all of its tax positions and make a determination as to whether its position is more-likely-than-not to be sustained upon examination by regulatory 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 ultimate settlement or disposition of the underlying issue.

The Company recognized the cumulative impact of the adoption of FIN 48 as a \$224,000 increase to its liability for unrecognized tax benefits with a corresponding increase to its accumulated deficit balance as of April 1, 2007. As of April 1, 2007 and March 31, 2008, the Company's gross unrecognized tax benefits were \$185,000 and \$1.4 million, respectively, of which \$78,000 and \$88,000, respectively, if recognized, would affect the Company's effective tax rate. The gross unrecognized tax benefits differ from the amount that would affect the Company's effective tax rate due primarily to the impact of the valuation allowance on such differences.

The Company's continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. As of March 31, 2008 and April 1, 2007, the Company had accrued cumulatively \$21,000 and \$39,000 respectively, for the payment of interest and penalties.

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits is as follows (in thousands):

| | | |
|--|----|-------|
| Gross unrecognized tax benefits at April 1, 2007 | \$ | 185 |
| Increases in tax positions for prior year | | 1,160 |
| Decrease in tax positions for prior year | | (147) |
| Increase in tax positions for current year | | 327 |
| Decrease in tax positions for current year | | |
| Settlements | | |
| Lapse in statute of limitation | | (136) |

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| | | |
|---|----|-------|
| Gross unrecognized tax benefits at March 31, 2008 | \$ | 1,389 |
|---|----|-------|

During the next twelve months, it is reasonably possible that, as a result of the expiration of the statute of limitations, the Company may decrease the amount of its gross unrecognized tax benefits by approximately \$408,000. The gross unrecognized tax benefits subject to potential decrease involve various timing differences.

The Company is subject to taxation in the United States and various states. The Company is subject to U.S. federal tax examination for fiscal tax years ended March 31, 2005 and state as well as local income tax examination for fiscal tax years ended March 31, 2004.

Stock-Based Compensation

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Effective April 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which replaced SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), superseded Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and amended SFAS No. 95, *Statement of Cash Flows*. Prior to April 1, 2006, the Company followed the disclosure-only provisions of SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, and, accordingly, accounted for its stock-based compensation plans using the intrinsic value method under APB 25 and related interpretations.

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

The fair value concepts were not changed significantly as a result of implementing SFAS 123R; however, in adopting SFAS 123R, companies must choose among alternative valuation models and amortization assumptions. After assessing alternative valuation models and amortization assumptions, the Company continued to use both the Black-Scholes-Merton (BSM) option-pricing formula and straight-line amortization of compensation expense over the requisite service period of stock option grants. The Company will reconsider use of this model if additional information becomes available in the future that indicates another model would be more appropriate, or if grants issued in future periods have characteristics that cannot be reasonably estimated using this model. SFAS 123 did not require the estimation of forfeitures in the calculation of stock compensation expense; however, SFAS 123R does require such estimation and upon adoption of SFAS 123R, the Company changed its methodology to include an estimate of forfeitures.

In addition, in accordance with SFAS 123R, SFAS 109 and EITF Topic D-32, *Intraperiod Tax Allocation of the Tax Effect of Pretax Income from Continuing Operations*, the Company has elected to recognize excess income tax benefits from stock option exercises in additional paid-in capital only if an incremental income tax benefit would be realized after considering all other tax attributes presently available to the Company. The Company measures the tax benefit associated with excess tax deductions related to stock-based compensation expense by multiplying the excess tax deductions by the statutory tax rates.

The following table illustrates the effect on net income and earnings per share for the year ended March 31, 2006 as if the Company had applied the fair value recognition provisions of SFAS 123R to options granted under the Company's stock option plans. For purposes of this pro forma disclosure, the fair value of the options was estimated using the BSM option-pricing formula and amortized on a straight-line basis to expense over the options' vesting period:

| | Year Ended March 31, 2006 | |
|--|---|---------|
| | (In thousands, except per share amounts) | |
| Net income as reported | \$ | 80 |
| Add: Stock-based compensation expense included in net income as reported | | 725 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards | | (1,108) |
| Net loss pro forma | \$ | (303) |
| Basic and diluted earnings per share as reported | \$ | 0.00 |
| Basic and diluted loss per share pro forma | \$ | (0.01) |

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 consolidated statements of operations.

Advertising Expenses

Advertising costs are expensed in the period incurred and totaled \$172,000, \$152,000, and \$185,000 in the years ended March 31, 2008, 2007 and 2006, respectively.

Warranty

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

recognized. The accrued warranty provision is included within accrued expenses on the accompanying consolidated balance sheets.

Repair and Maintenance Costs

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

Comprehensive Income

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

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. In February 2008 the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for non-financial assets and liabilities to fiscal years beginning after November 15, 2008. Generally, this statement will be applied prospectively. The Company is currently evaluating the impact of SFAS 157 and expects to adopt SFAS 157 in the first quarter of its fiscal year ending March 31, 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is evaluating the impact that the adoption of SFAS 159 will have on its results of operations and financial condition and expects to adopt SFAS 159 in its fiscal year ending March 31, 2009.

2. Supplementary Financial Information

Inventories

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

| | 2008 | March 31, (In thousands) | 2007 |
|------------------------|------|-----------------------------|----------|
| Materials and supplies | \$ | 3,031 | \$ 4,705 |
| Work in process | | 345 | 366 |
| Finished goods | | 850 | 1,308 |
| | \$ | 4,226 | \$ 6,379 |

Goodwill and Intangible Assets

| | March 31, 2008 | | March 31, 2007 | |
|---|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| | (In thousands) | | | |
| Intangible assets subject to amortization: | | | | |
| Developed Technology | \$ 495 | \$ (381) | \$ 495 | \$ (280) |
| Patents | 317 | (174) | 317 | (128) |
| Total | \$ 812 | \$ (555) | \$ 812 | \$ (408) |

Amortization expense for intangible assets subject to amortization was \$147,000 for the years ended March 31, 2008, 2007 and 2006. Future estimated amortization expense is as follows:

Year Ending March 31: (In thousands)

| | |
|------|--------|
| 2009 | \$ 147 |
| 2010 | 58 |
| 2011 | 46 |

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257

At March 31, 2008, goodwill was comprised of \$18.0 million associated with the October 2004 merger of the Iteris Subsidiary (Note 1); \$9.6 million associated with the acquisitions of the Rockwell International Transportation Systems Group, Meyer Mohaddes Associates and the Vigen Systems Consulting Group; and \$200,000 associated with the purchase of the assets of Mil-Lektron, a complementary product to the Company's Vantage video detection business.

Warranty Reserve Activity

The following table presents activity in accrued warranty obligations:

| | 2008 | Year Ended March 31, 2007 (In thousands) | | 2006 |
|------------------------------------|--------|--|----|-------|
| Balance at beginning of year | \$ 520 | \$ 519 | \$ | 326 |
| Additions charged to cost of sales | 347 | 630 | | 517 |
| Warranty claims | (373) | (629) | | (324) |
| Balance at end of year | \$ 494 | \$ 520 | \$ | 519 |

Earnings Per Share

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

| | 2008 | Year Ended March 31, 2007 (In thousands, except per share amounts) | | 2006 |
|---|-----------|--|----|--------|
| Numerator: | | | | |
| Net income | \$ 12,163 | \$ 2,918 | \$ | 80 |
| Denominator: | | | | |
| Weighted average common shares used in basic computation | 32,723 | 29,698 | | 28,182 |
| Dilutive stock options | 1,973 | 3,346 | | 3,818 |
| Dilutive warrants | 17 | 304 | | 737 |
| Weighted average common shares used in dilutive computation | 34,713 | 33,348 | | 32,737 |
| Earnings per share: | | | | |
| Basic | \$ 0.37 | \$ 0.10 | \$ | 0.00 |
| Diluted | \$ 0.35 | \$ 0.09 | \$ | 0.00 |

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

| | 2008 | Year Ended March 31, 2007 (In thousands) | | 2006 |
|------------------------|-------|--|--|-------|
| Stock options | 520 | 582 | | 470 |
| Warrants | 1,170 | 1,240 | | 1,265 |
| Convertible debentures | 2,661 | 2,729 | | 2,729 |

3. Costs and Estimated Earnings on Uncompleted Contracts

Costs incurred, estimated earnings and billings on uncompleted long-term contracts are as follows:

| | 2008 | March 31, (In thousands) | 2007 |
|---|------|-----------------------------|-----------|
| Total estimated contract value | \$ | 77,557 | \$ 74,794 |
| Costs incurred on uncompleted contracts | \$ | 23,415 | \$ 20,688 |
| Estimated earnings | | 2,342 | 2,069 |
| | | 25,757 | 22,757 |
| Less billings to date | | (21,532) | (19,915) |
| | \$ | 4,225 | \$ 2,842 |
| Included in accompanying consolidated balance sheets: | | | |
| Costs and estimated earnings in excess of billings on uncompleted contracts | \$ | 5,351 | \$ 3,689 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | | (1,126) | (847) |
| | \$ | 4,225 | \$ 2,842 |

Costs and estimated earnings in excess of billings at March 31, 2008 and 2007 include \$828,000 and \$786,000, respectively, that were not billable as certain milestone objectives specified in the contracts had not been attained. Substantially all costs and estimated earnings in excess of billings at March 31, 2008 are expected to be billed and collected during the year ending March 31, 2009.

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

Revolving Line of Credit

In October 2006, the Company entered into a new two-year credit facility with a bank. At March 31, 2008, the facility provided line of credit borrowings of up to \$10.0 million. Under the credit facility, the Company may borrow against its eligible accounts receivable and eligible inventory, as defined in the credit agreement. Interest on borrowed amounts under the line of credit is payable monthly at the current stated prime rate plus 1.00% (6.25% at March 31, 2008). Additionally, the Company is obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeds the average daily principal balance during the preceding month. The credit facility requires \$2,000 in monthly collateral management fees and includes an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. Additionally, the Company paid commitment fees of \$40,000 in October 2006 and \$50,000 in October 2007. The credit facility is secured by substantially all of the assets of the Company.

On March 31, 2008, the available credit under the credit facility was \$8.6 million, all of which was unused.

Long-Term Debt

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

March 31,

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| | 2008 | (In thousands) | 2007 |
|-----------------------------|------|----------------|----------|
| Convertible debentures, net | \$ | 7,566 | \$ 9,410 |
| Bank term note | | 210 | 1,573 |
| Promissory note to landlord | | | 646 |
| Other | | 34 | 78 |
| | | 7,810 | 11,707 |
| Less current portion | | (244) | (1,947) |
| | \$ | 7,566 | \$ 9,760 |

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

The debentures are due in full on May 19, 2009, provide for 6.0% annual interest, payable quarterly, and are convertible at the holder's option into the Company's common stock at an initial conversion price of \$3.61 per share, subject to certain adjustments, including adjustments for dilutive issuances. From May 19, 2008, until the maturity date, the Company may redeem the debentures at 110% of the principal amount.

During the year ended March 31, 2008, the Company paid \$1.8 million to retire \$2.1 million of convertible debentures early. In connection with this early retirement, the Company recorded a gain of \$224,000, which is included within other income in the accompanying consolidated statement of operations for the year ended March 31, 2008. Additionally, \$250,000 of convertible debentures were previously converted into 69,252 shares of common stock. At March 31, 2008, \$7.8 million of the originally issued convertible debentures remained outstanding.

Bank Term Note. In October 2004, the Company entered into a \$5.0 million term note payable with a bank. The note was due on May 27, 2008, and provided for monthly principal payments of approximately \$104,000. In October 2006, the term note was assumed by the Company's new bank as part of the Company's new credit facility. The new term note was also due on May 27, 2008 and provided for monthly principal payments of approximately \$104,000. Interest accrued under the new term note at an annual rate of 8.75%. The final payment against this term note was made in June 2008.

Promissory Note to Landlord. The Company had an unsecured promissory note payable to the landlord of its previous headquarters. Under the terms of the note agreement, interest was payable quarterly and accrued at a rate of prime plus 2.0%. In October 2006, January 2007, April 2007 and July 2007, the Company made required quarterly principal payments of \$323,000. As of March 31, 2008, all principal and interest under this note was paid in full.

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

| Year Ending March 31, (In thousands) | |
|---|----------|
| 2009 | \$ 244 |
| 2010 | 7,750 |
| | 7,994 |
| Less: unamortized debt discount | (184) |
| | \$ 7,810 |

5. Income Taxes

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The reconciliation of the Company's income tax benefit to taxes computed at U.S. federal statutory rates is as follows:

| | 2008 | Year Ended March 31, 2007 (In thousands) | 2006 |
|---|------------|--|----------|
| Income tax (benefit) provision at statutory rates | \$ 2,131 | \$ 536 | \$ (284) |
| State income taxes net of federal benefit | (675) | (147) | (85) |
| Change in valuation allowance associated with federal deferred tax assets | (7,558) | (1,895) | (892) |
| Compensation charges | 194 | | 222 |
| Unrecognized tax benefits | (133) | | |
| AMT and foreign taxes | 40 | 24 | 46 |
| Other permanent differences | 101 | 139 | 108 |
| Income tax benefit | \$ (5,900) | \$ (1,343) | \$ (885) |

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The components of deferred tax assets and liabilities are as follows:

| | 2008 | March 31, (In thousands) | 2007 |
|--|------|-----------------------------|-----------|
| Deferred tax assets: | | | |
| Net operating losses | \$ | 16,777 | \$ 18,806 |
| Credit carry forwards | | 164 | 1,401 |
| Deferred compensation and payroll | | 1,359 | 2,032 |
| Bad debt allowances and other reserves | | 601 | 524 |
| Acquired intangibles | | | 67 |
| Other, net | | 167 | |
| Total deferred tax assets | | 19,068 | 22,830 |
| Valuation allowance | | (7,887) | (19,543) |
| Net deferred tax assets | | 11,181 | 3,287 |
| Deferred tax liabilities: | | | |
| Other, Net | | (490) | (135) |
| Property and equipment | | (160) | (125) |
| Acquired intangibles | | (183) | |
| Total deferred tax liabilities | | (833) | (260) |
| Net deferred tax assets | \$ | 10,348 | \$ 3,027 |
| Current portion of net deferred taxes | | | |
| Current portion of net deferred taxes | \$ | 2,541 | \$ 494 |
| Long-term portion of net deferred taxes | | 7,807 | 2,533 |
| Net deferred tax assets | \$ | 10,348 | \$ 3,027 |

The components of current and deferred federal and state income tax benefits and provisions are as follows:

| | 2008 | Year Ended March 31, 2007 (In thousands) | 2006 |
|-------------------------------------|------------|--|----------|
| Current income tax provision | | | |
| Federal | \$ 94 | \$ 25 | \$ 9 |
| State | 40 | 32 | 3 |
| Foreign | 40 | 24 | 46 |
| Deferred income tax benefit | | | |
| Federal | (5,011) | (1,170) | (812) |
| State | (1,063) | (254) | (131) |
| Net income tax benefit | \$ (5,900) | \$ (1,343) | \$ (885) |

At March 31, 2008, the Company had approximately \$581,000 in federal general business credit carryforwards that begin to expire in 2014 and \$818,000 in state general business credit carryforwards that can be carried forward indefinitely. The Company had \$44.7 million of federal net operating loss carryforwards at March 31, 2008 that begin to expire in 2019 and \$16.6 million of state net operating loss carryforwards that begin to expire in 2013.

Prior to May 28, 2004, the Iteris Subsidiary was required to file a separate federal income tax return. On May 28, 2004, the Company acquired a greater than 80% ownership interest in the Iteris Subsidiary. From that date forward, income taxes are provided on a consolidated basis for federal income tax purposes. Due to changes in stock ownership, the prior year \$49.8 million of federal net operating loss carryforwards and other federal tax attributes of the Company are subject to a Section 382 limitation estimated at approximately \$7.8 million annually which can be

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utilized to offset federal consolidated taxable income. To the extent such limitation is not exceeded in a particular year, the excess limitation accumulates and adds to subsequent years' limitations.

As a result of SFAS 123R, our deferred tax assets at March 31, 2008 do not include \$1.9 million of excess tax benefits from employee stock option exercises that are a component of our net operating loss carryforwards. Stockholders' equity will be increased by \$1.9 million if and when such excess tax benefits are ultimately realized.

At March 31, 2008, the Company recorded a valuation allowance against its net deferred tax assets of approximately \$7.9 million for that portion of deferred tax assets that it is more likely than not will not be realized. In making such determination, a review of all available positive and negative evidence was considered, including scheduled reversal of deferred tax liabilities, potential carryback, projected future taxable income, tax planning strategies, and recent financial performance. Any future benefits recognized from the reduction of the valuation allowance will result in a reduction of income tax expense.

Unremitted earnings of the Company's foreign subsidiary have been included in the consolidated financial statements without giving effect to the United States taxes that may be payable on distribution to the United States because it is not anticipated that such earnings will be remitted to the United States. If remitted, the additional United States taxes would not be material.

6. Commitments and Contingencies

Litigation

On June 29, 2004, a supplier to Mariner Networks, Inc., a former subsidiary of the Company that was discontinued in the fiscal year ended March 31, 2002, filed a complaint in Orange County Superior Court against the Company alleging various breaches of written contract claims arising out of alleged purchase orders. On July 20, 2006, the Company entered into a settlement agreement in connection with this matter. The dispute was settled in full for \$688,000 payable as follows: (i) the Company issued 88,912 shares of the Company's common stock on August 18, 2006 valued at \$213,000 based on the closing sales price of the Company's common stock on the date of issuance; (ii) the Company made a cash payment of \$125,000 on October 20, 2006; and (iii) the Company is obligated to pay \$350,000 in cash in equal monthly installments of \$9,700 over three years beginning in November 2006. In connection with this settlement, the Company recorded a charge of \$635,000, representing the fair value of the settlement, within other expense in the accompanying consolidated statement of operations for the year ended March 31, 2007.

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

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

Operating Leases

In May 2007, the Company entered into an agreement to lease 52,000 square feet of space in Santa Ana, California for a term of 88 months. In September 2007, the Company relocated its headquarters and principal operations into this space. The monthly lease rate is \$102,000 during the first year of the lease and increases each year thereafter, up to a maximum of \$120,000 during the last year of the lease. The lease may be

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extended for a period of five years, at the option of the Company, at a lease rate to be based on the market lease rate for comparable property determined as of the commencement date of the extension period. Additionally, the lease agreement provides for \$1.8 million in incentives in the form of tenant improvement allowances, which the Company recorded as deferred rent and capitalized leasehold improvements in its consolidated balance sheet. The deferred rent amount will reduce future rent expense over the term of the lease, and the capitalized leasehold improvements amount will be depreciated over the initial term of the lease (the estimated useful life of the related leasehold improvements).

The Company has lease commitments for facilities in various locations throughout the United States. Future minimum rental payments under these noncancelable operating leases at March 31, 2008 were as follows:

**Fiscal Year Ending March 31,
(In thousands)**

| | | |
|------------|----|-------|
| 2009 | \$ | 1,594 |
| 2010 | | 1,431 |
| 2011 | | 1,366 |
| 2012 | | 1,332 |
| 2013 | | 1,363 |
| Thereafter | | 2,460 |
| Total | \$ | 9,546 |

Rent expense totaled \$2.1 million, \$2.2 million and \$1.9 million, respectively, for the years ended March 31, 2008, 2007 and 2006.

The Company previously had recorded on its consolidated balance sheet a deferred gain related to the May 2002 sale and leaseback of its prior headquarters in Anaheim, California. The deferred gain was amortized over the term of the underlying lease, which terminated in September 2007, and resulted in a realized gain of \$165,000 in the fiscal year ended March 31, 2008 and \$284,000 in the fiscal years ended March 31, 2007 and 2006.

The Company previously subleased office space to MAXxess Systems, Inc. (MAXxess), a former subsidiary of the Company that was sold by the Company in September 2003 and is currently owned by an investor group that includes two of the Company's directors, one of which is the Chief Executive Officer of MAXxess. At March 31, 2008, MAXxess owed the Company an aggregate of \$274,000 related to this sublease, which terminated in September 2007, and certain related ancillary services that were provided by the Company to MAXxess. Although the Company has fully reserved for amounts owed to it by MAXxess under the terms of this sublease, the Company intends to pursue full payment of any and all amounts due from MAXxess.

Inventory Purchase Commitments

At March 31, 2008, the Company had firm commitments to purchase inventory in the amount of \$2.3 million during the first and second quarters of its fiscal year ending March 31, 2009.

Deferred Compensation Plan

In 1986, the Company adopted the Executive Deferral Plan (the 1986 Plan) under which certain executives were able to defer a portion of their annual compensation into the 1986 Plan. All deferred amounts earned interest, generally with no guaranteed rate of return. During the year ended March 31, 2003, the Company adopted the Deferred Compensation Plan, and all assets of the 1986 Plan were transferred into the Deferred Compensation Plan. No compensation withholdings were deferred under the 1986 Plan or the Deferred Compensation Plan in the years ended March 31, 2008, 2007 and 2006.

At March 31, 2008, the Deferred Compensation Plan held 167,177 shares of the Company's common stock and \$5,000 in cash, which the Company has presented as an aggregated \$391,000 deferred compensation plan liability in the accompanying consolidated balance sheet. At March 31, 2007, the Deferred Compensation Plan held 310,510 shares of the Company's common stock and \$15,000 in cash. Changes in the value of Company common stock held by the Deferred Compensation Plan are determined based on changes in the quoted market price of the

Company's common stock at the close of each reporting period and presented within operating expenses in the accompanying consolidated statements of operations. As a result of such changes in the value of Company common stock, the Company recorded expense of \$21,000, a benefit of \$91,000 and expense of \$48,000 in the years ended March 31, 2008, 2007 and 2006, respectively. The original \$202,000 cost basis of shares of Company common stock held in the Deferred Compensation Plan at March 31, 2008 has been recorded as a contra-equity account in the accompanying consolidated financial statements. On June 3, 2008, substantially all of the remaining assets of the Deferred Compensation Plan were distributed.

7. Redeemable Common Stock

In connection with the merger of the Iteris Subsidiary into the Company (Note 1) in May 2004, the Company acquired 547,893 shares of common stock of the Iteris Subsidiary in exchange for the issuance of 1,219,445 shares of the Company's common stock, which was valued at \$3.4 million at the date of issuance. Beginning on May 28, 2007, the holder of these shares had the right to require the Company to repurchase up to 100% of the shares at a purchase price of \$1.438 per share.

All such rights to require the repurchase of these shares expired on September 28, 2007. Because these rights were outside of the control of the Company, the Company previously had classified the \$3.4 million value of the 1,219,445 shares as redeemable common stock on its consolidated balance sheet. Upon the expiration of these rights, the Company reclassified \$122,000 to common stock, representing the par value of the shares, and \$3.3 million to additional paid-in capital on its consolidated balance sheet.

8. Stockholders Equity

Preferred Stock

The Company's certificate of incorporation provides for the issuance of up to 2,000,000 shares of preferred stock. As of March 31, 2008 and 2007, there were no outstanding shares of preferred stock, and the Company does not have any plans to issue any shares of preferred stock. The Company's Board of Directors is authorized to issue from time to time such authorized but unissued shares of preferred stock in one or more series and to fix or alter the designations, preferences, rights and any qualifications, limitations or restrictions of the shares of each such series, including the dividend, conversion, voting, redemption and liquidation rights.

Common Stock and Common Stock Warrants

On September 28, 2006, the Company issued warrants to purchase an aggregate 246,250 shares of common stock at an exercise price of \$3.25 with a five-year life to an existing shareholder in exchange for the early exercise of 1,250,000 outstanding warrants with an exercise price of \$1.61. The new warrants were immediately exercisable and are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price greater than or equal to two times the exercise price of the warrants. The fair value of the new warrants was \$320,000 calculated using the Black-Scholes-Merton (BSM) option-pricing formula. The warrants were considered a cost of raising capital and were recorded in equity.

In connection with the issuance of the new warrants, the Company is party to a registration rights agreement that contains provisions under which the Company could be subjected to liquidated damages should it fail to maintain effective registration statements for the shares of common stock issuable upon exercise of the warrants. These warrants have been accounted for within equity in the consolidated balance sheets as of March 31, 2008 and 2007 in accordance with EITF Issue No. 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and, accordingly, no liabilities have been recorded in connection therewith. As of March 31, 2008, no liquidated damages were payable under the provisions of the registration rights agreement associated with these warrants.

The following table summarizes information regarding outstanding warrants to purchase the Company's common stock as of March 31, 2008:

| Range of Exercise Prices | Warrants Outstanding at March 31, 2008 | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price |
|--------------------------|---|--|------------------------------------|
| | (In thousands, except per share amounts) | | |
| \$1.42 | 15 | 5.42 | \$ 1.42 |

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| | | | | |
|------------------|-------|------|----|------|
| \$3.25 | 246 | 2.91 | \$ | 3.25 |
| \$3.61 to \$4.03 | 674 | 1.13 | \$ | 3.93 |
| \$5.00 to \$5.26 | 230 | 1.66 | \$ | 5.18 |
| | 1,165 | 1.67 | \$ | 4.00 |

All of the warrants were exercisable at March 31, 2008. Warrants to purchase an aggregate of 246,260 shares of common stock at an exercise price of \$3.25 per share are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price equal to or greater than two times the exercise price of the warrants. Warrants to purchase an aggregate of 75,000 shares of common stock at an exercise price of \$5.00 per share are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price equal to or greater than one and a half times the exercise price of the warrants.

Common stock reserved for future issuance at March 31, 2008:

| | (In thousands) |
|--|----------------|
| Issuable under stock options plans | 4,985 |
| Issuable upon the exercise of warrants | 1,165 |
| | 6,150 |

9. Associate Benefit Plans

Stock Option Plan

On September 21, 2007, the Company's stockholders approved the 2007 Omnibus Incentive Plan (the 2007 Plan), which provides that options to purchase shares of the Company's unissued common stock may be granted to employees, officers, consultants and directors to the Company at exercise prices which are equal to or greater than the fair market value of the Company's common stock on the date of grant. Options expire no more than ten years after the date of grant and generally vest at the rate of 25% on each of the first four anniversaries of the grant date. The 2007 Plan also allows for the issuance of stock appreciation rights, restricted stock, restricted stock units and other stock-based awards based on the value of the Company's common stock. New shares are issued to satisfy stock option exercises and share issuances under the 2007 Plan. As of March 31, 2008, options to purchase an aggregate of 389,000 shares of common stock were outstanding under the 2007 Plan.

The Company's 1997 Stock Incentive Plan (the 1997 Plan) terminated in September 2007; however, all stock options outstanding under the 1997 Plan will remain outstanding pursuant to the terms of such stock options. As of March 31, 2008, options to purchase 1.4 million shares of the Company's common stock were outstanding under the 1997 Plan.

In connection with the merger of the Company and the Iteris Subsidiary (Note 1), the Company assumed the 1998 Stock Incentive Plan of the Iteris Subsidiary (the 1998 Plan) and all outstanding options granted thereunder. As of March 31, 2008, options to purchase 2.7 million shares of the Company's common stock were outstanding under the 1998 Plan. No further options may be granted under the 1998 Plan.

Certain options granted under the 2007 Plan, the 1997 Plan and the 1998 Plan (collectively, the Plans) provide for accelerated vesting of unvested options in the event of a change in control under certain circumstances. These change-in-control provisions meet the criteria of a performance condition under SFAS 123R.

A summary of activity in the Plans for the year ended March 31, 2008 is as follows:

| Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value |
|---------|--|---|------------------------------|
|---------|--|---|------------------------------|

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(In thousands, except per share amounts)

| | | | | |
|---|---------|--------|-----|---------|
| Options outstanding at March 31, 2007 | 5,818 | \$1.60 | 3.4 | |
| Granted | 389 | \$2.38 | N/A | |
| Exercised | (1,515) | \$0.90 | N/A | |
| Forfeited | (53) | \$2.92 | N/A | |
| Expired | (115) | \$3.90 | N/A | |
| Options outstanding at March 31, 2008 | 4,524 | \$1.83 | 3.7 | \$3,761 |
| Vested and expected to vest at March 31, 2008 | 4,400 | \$1.81 | 3.6 | \$3,759 |
| Options exercisable at March 31, 2008 | 3,875 | \$1.72 | 2.8 | \$3,750 |
| Options exercisable at March 31, 2008 pursuant to a change-in-control | 4,524 | \$1.83 | 3.7 | \$3,761 |

At March 31, 2008, there were 461,000 shares of common stock available for grant under the 2007 Plan.

For the years ended March 31, 2008, 2007 and 2006, the Company received \$1.4 million, \$1.1 million and \$296,000, respectively, in cash from the exercise of stock options.

Stock-Based Compensation Expense

Total stock-based compensation expense for the years ended March 31, 2008, 2007 and 2006 was \$290,000, \$288,000, and \$725,000, respectively. No income tax benefit was realized from activity in the Plans during the years ended March 31, 2008, 2007 and 2006.

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

| | 2008 | Year Ended March 31, 2007 | 2006 |
|-------------------------------------|------|------------------------------|------|
| Dividend yield | 0.0% | 0.0% | 0.0% |
| Expected life - years | 7.0 | 7.0 | 7.0 |
| Risk-free interest rate | 3.8% | 4.7% | 5.5% |
| Expected volatility of common stock | 0.8 | 0.9 | 0.5 |

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

| | 2008 | Year Ended March 31, 2007 | 2006 |
|---|--|------------------------------|---------|
| | (In thousands, except per share amounts) | | |
| Weighted average grant date fair value per share of options granted | \$ 1.83 | \$ 1.92 | \$ 1.77 |
| Intrinsic value of options exercised | \$ 2,555 | \$ 2,288 | \$ 295 |

At March 31, 2008, there was \$1.2 million of total unrecognized compensation expense related to unvested stock options. This expense is expected to be recognized over a weighted-average period of approximately 3.5 years.

Associate Incentive Programs

Under the terms of a Profit Sharing Plan, the Company may contribute to a trust fund such amounts as are determined annually by the Board of Directors. No contributions were made during the years ended March 31, 2008, 2007 and 2006.

In May 1990, the Company adopted a 401(k) Plan as an amendment and replacement of the former Associate Stock Purchase Plan that was an additional feature of the Profit Sharing Plan. Under the 401(k) Plan, eligible associates voluntarily contribute to the plan, up to IRS maximums, through payroll deductions. The Company matches up to 90% of contributions, based on years of service, up to a stated limit. Under the provisions of the 401(k) Plan, associates have various investment choices, one of which is the purchase of Iteris, Inc. common stock at market

price. Company matching contributions were approximately \$401,000, \$480,000, and \$317,000 and for the years ended March 31, 2008, 2007, and 2006, respectively.

10. Business Segment and Geographic Information

The Company currently operates in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes Vantage vehicle detection systems for traffic intersection control and certain highway traffic data collection applications. The Vehicle Sensors segment is comprised of all activities related to AutoVue lane departure warning systems. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Prior to April 1, 2007, certain expenses, such as interest, amortization of certain intangibles and certain corporate expenses were not allocated to the segments. Beginning April 1, 2007, the Company increased the portion of its corporate expenses that it allocates to its segments such that substantially all corporate expenses are allocated. Interest, amortization of certain intangibles and certain corporate expenses are still not allocated to the segments. The reportable segments are each managed separately because they manufacture and distribute distinct products or provide services with different processes. All segment revenues are derived from external customers.

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Selected financial information for the Company's reportable segments as of and for the years ended March 31, 2008, 2007 and 2006 is as follows:

| | Roadway Sensors | Vehicle Sensors | Transportation Systems | Total |
|---|--------------------|--------------------|---------------------------|-----------|
| | (In thousands) | | | |
| Year Ended March 31, 2008 | | | | |
| Product revenue from external customers | \$ 28,452 | \$ 10,016 | \$ | \$ 38,468 |
| Service and other revenue from external customers | | 1,858 | 24,837 | 26,695 |
| Stock-based compensation | 18 | 45 | 27 | 90 |
| Depreciation | 107 | 130 | 147 | 384 |
| Allocated goodwill | 8,197 | 4,671 | 14,906 | 27,774 |
| Segment income | 5,062 | 552 | 2,094 | 7,708 |
| Year Ended March 31, 2007 | | | | |
| Product revenue from external customers | \$ 27,261 | \$ 6,408 | \$ | \$ 33,669 |
| Service and other revenue from external customers | | 2,579 | 22,049 | 24,628 |
| Stock-based compensation | 37 | 54 | 78 | 169 |
| Depreciation | 82 | 138 | 126 | 346 |
| Allocated goodwill | 8,197 | 4,671 | 14,906 | 27,774 |
| Segment income (loss) | 6,035 | (2,625) | 2,551 | 5,961 |
| Year Ended March 31, 2006 | | | | |
| Product revenue from external customers | \$ 22,446 | \$ 5,865 | \$ | \$ 28,311 |
| Service and other revenue from external customers | | 2,845 | 19,330 | 22,175 |
| Stock-based compensation | 177 | 101 | 342 | 620 |
| Depreciation | 132 | 189 | 266 | 587 |
| Allocated goodwill | 8,197 | 4,671 | 14,906 | 27,774 |
| Segment income (loss) | 3,420 | (2,476) | 1,842 | 2,786 |

The Roadway Sensors segment had one customer with combined revenue representing 16.9% of total segment revenue for the year ended March 31, 2008; one customer with revenue representing 26.5% of total segment revenue for the year ended March 31, 2007; and one customer with revenue representing 25.9% of total segment revenue for the year ended March 31, 2006. The Vehicle Sensors segment had three customers with combined revenue representing 60.9% of total segment revenue for the year ended March 31, 2008; three customers with combined revenue representing 64.2% of total segment revenue for the year ended March 31, 2007; and two customers with combined revenue representing 70.7% of total segment revenue for the year ended March 31, 2006. The Transportation Systems segment had one customer with revenue representing 13.3% of total segment revenue for the year ended March 31, 2007.

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

| | 2008 | March 31, 2007 (In thousands) | 2006 |
|--------------------------------------|----------|-------------------------------------|----------|
| Segment income | | | |
| Total income for reportable segments | \$ 7,708 | \$ 5,961 | \$ 2,786 |
| Unallocated amounts: | | | |
| Corporate and other expenses | (266) | (1,986) | (2,020) |
| Amortization of intangible assets | (147) | (147) | (147) |
| Other income (expense), net | 252 | (653) | 35 |
| Interest expense, net | (1,284) | (1,600) | (1,459) |
| Income (loss) before income taxes | \$ 6,263 | \$ 1,575 | \$ (805) |

The Company's revenues are generated and the Company's assets are held substantially in the United States.

11. Quarterly Financial Data (Unaudited)

| | Total Net Sales and Contract Revenues | Gross Profit | Net Income | Basic Earnings per Share | Diluted Earnings per Share |
|--------------------|--|-----------------|---------------|--------------------------------|----------------------------------|
| | (In thousands, except per share amounts) | | | | |
| June 30, 2007 | \$ 15,757 | \$ 7,094 | \$ 1,096 | \$ 0.03 | \$ 0.03 |
| September 30, 2007 | 16,976 | 7,262 | 2,170 | 0.07 | 0.06 |
| December 31, 2007 | 15,363 | 6,500 | 954 | 0.03 | 0.03 |
| March 31, 2008 | 17,067 | 7,441 | 7,943 | 0.24 | 0.23 |
| | \$ 65,163 | \$ 28,297 | \$ 12,163 | \$ 0.37* | \$ 0.35* |
| June 30, 2006 | \$ 13,816 | \$ 5,719 | \$ 279 | \$ 0.01 | \$ 0.01 |
| September 30, 2006 | 14,466 | 5,957 | 732 | 0.03 | 0.02 |
| December 31, 2006 | 14,488 | 5,676 | 310 | 0.01 | 0.01 |
| March 31, 2007 | 15,527 | 6,656 | 1,597 | 0.05 | 0.05 |
| | \$ 58,297 | \$ 24,008 | \$ 2,918 | \$ 0.10* | \$ 0.09* |

* Annual per share amounts may not agree to the sum of the quarterly per share amounts due to differences between average shares outstanding during the periods.

Schedule II

Valuation and Qualifying Accounts (In thousands)

| Description | Balance at Beginning of Period | Charged to Costs and Expenses | Charged to Accounts | Balance at End of Period |
|------------------------------------|--------------------------------------|-------------------------------------|------------------------|-----------------------------|
| Year Ended March 31, 2008 | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | \$ 664 | \$ 360 | \$ (4) | \$ 1,020 |
| Reserve for inventory obsolescence | 844 | 576 | (601) | 819 |
| Year Ended March 31, 2007 | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | \$ 429 | \$ 220 | \$ 15 | \$ 664 |
| Reserve for inventory obsolescence | 592 | 420 | (168) | 844 |
| Year Ended March 31, 2006 | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | \$ 239 | \$ 275 | \$ (85) | \$ 429 |
| Reserve for inventory obsolescence | 514 | 312 | (234) | 592 |