ITERIS, INC.
Form 10-Q
February 14, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2010

OR

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

For the transition period from to

Commission file number: 001-08762

ITERIS, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**95-2588496** (I.R.S. Employer Identification No.)
1700 Carnegie Avenue, Suite 100 **Santa Ana, California** (Address of principal executive office)	**92705** (Zip Code)

(949) 270-9400

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

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 o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

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

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ITERIS, INC.

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

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

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

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Iteris, Inc.

Unaudited Condensed Consolidated Balance Sheets

(In thousands, except par value)

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

See accompanying notes.

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Iteris, Inc.

Unaudited Condensed Consolidated Statements of Operations

(In thousands, except per share amounts)

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

See accompanying notes.

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Iteris, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)

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

See accompanying notes.

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Iteris, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

December 31, 2010

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

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

Basis of Presentation

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

Use of Estimates

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

Revenue Recognition

Net Sales

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

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

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

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

Contract Revenues

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

Foreign Currency

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

Concentration of Credit Risk

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

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

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

Fair Values of Financial Instruments

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

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Cash and Cash Equivalents

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

Allowance for Doubtful Accounts

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

Costs in Excess of Billings on Uncompleted Contracts

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

Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts

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

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

Inventories

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

Property and Equipment

Property and equipment are recorded at cost and are depreciated using the straight-line method over the estimated useful life ranging from three to eight years. Leasehold improvements are depreciated over the term of the related lease or the estimated useful life of the improvement, whichever is shorter.

Goodwill and Long-Lived Assets

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

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We also evaluate long-lived assets used in operations for impairment when indicators of impairment are present. Reviews are performed to determine whether the carrying value of assets is impaired, based on a comparison of undiscounted expected future cash flows to the carrying value of the related net assets. If this comparison indicates that there is impairment, the impaired asset is written down to fair value, which is typically calculated using discounted expected future cash flows and a discount rate based upon our weighted average cost of capital adjusted for risks associated with the related operations. Impairment is based on the excess of the carrying amount over the fair value of those assets.

Income Taxes

We utilize the liability method of accounting for income taxes, whereby deferred taxes are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities using enacted tax rates. A valuation allowance is recorded when it is more likely than not that all or a portion of the deferred tax assets will not be realized.

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

Stock-Based Compensation

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

Research and Development Expenditures

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

Shipping and Handling Costs

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

Sales Taxes

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

Warranty

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

Repair and Maintenance Costs

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

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Recent Accounting Pronouncements

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

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

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

2. Supplemental Financial Information

Inventories

The following table presents details of our inventories:

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

Intangible Assets

The following table presents details of our intangible assets:

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

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

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

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

Goodwill

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

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

Warranty Reserve Activity

The following table presents activity related to the warranty reserve:

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

Net Income (Loss) Per Share

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	2009	2010	2009
	(In thousands, except per share amounts)			
Numerator:				

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

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

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

3. Fair Value Measurements

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

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

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

4. Impairment of Goodwill

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

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

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

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

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

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

5. Revolving Line of Credit and Long-Term Debt

Revolving Line of Credit

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

Long-Term Debt Bank Term Note

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

6. Income Taxes

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

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

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

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

7. Commitments and Contingencies

Litigation and Other Contingencies

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

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

Related Party Transaction

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

8. Employee Benefit Plans

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

Stock Options

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

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

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

Restricted Stock Units

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

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Stock-Based Compensation Expense

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

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

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

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

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

9. Common Stock Warrants

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

Exercise Price per Share	Warrants Outstanding (In thousands)	Remaining Contractual Life (Years)
$ 1.42	15	2.7

	3.25	246	0.2
		261	

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

10. Business Segment Information

We currently operate in three reportable segments: Roadway Sensors, Vehicle Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage and VersiCam vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. This segment also includes our Pico compact video detection system, which was designed primarily to respond to international video detection needs. The Vehicle Sensors segment includes our lane departure warning products and is comprised of all of our activities related to vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Certain corporate expenses, including interest and amortization of intangible assets, are not allocated to the segments. The reportable segments are each managed separately because they manufacture and distribute distinct products or provide services with different processes. All segment revenues are derived from external customers.

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

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

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

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

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

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11. Subsequent Event

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

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

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This report, including the following discussion and analysis, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that are based on our current expectations, estimates and projections about our business and our industry, and reflect management s beliefs and certain assumptions made by us based upon information available to us as of the date of this report. When used in this report and the information incorporated herein by reference, the words expect(s), feel(s), believe(s), should, will, may, anticipate(s), estimate(s) and similar expressions or variations of these words are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to, statements regarding our anticipated growth, sales, revenue, expenses, profits, capital needs, competition, development plans, and manufacturing capabilities, the applications for and acceptance of our products and services, and the status of our facilities and product development. These statements are not guarantees of future performance and are subject to certain risks and uncertainties that could cause our actual results to differ materially from those projected. You should not place undue reliance on these forward-looking statements that speak only as of the date hereof. We encourage you to carefully review and consider the various disclosures made by us which describe certain factors which could affect our business, including in Risk Factors set forth in Part II, Item 1A of this report, before deciding to invest in our company or to maintain or increase your investment. We undertake no obligation to revise or update publicly any forward-looking statement for any reason, including to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

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

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

Roadway Sensors

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

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

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- VersiCam, our integrated camera and processor video detection system, is a cost-efficient video detection system for smaller intersections that require only a few detection points.

- Pico, our compact video detection system, was developed primarily to address international video detection needs, and was designed for easy installation and configuration.

- Our Abacus products take advantage of the large number of existing installed closed-circuit television video feeds monitoring roadways, signalized intersections, tunnels and bridges to allow for data collection and incident detection without the set-up and calibration generally required with other systems.

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

Vehicle Sensors

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

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

Transportation Systems

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

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

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

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

Critical Accounting Policies and Estimates

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

The accounting policies that affect our more significant judgments and estimates used in the preparation of our unaudited condensed consolidated financial statements are those relating to revenue recognition, accounts receivable, inventory, goodwill, warranty, income taxes, and stock-based compensation. These policies are described in further detail in our Annual Report on Form 10-K for fiscal 2010. There have been no significant changes in our critical accounting policies and estimates during the nine months ended December 31, 2010 as compared to what was previously disclosed in our Annual Report on Form 10-K for fiscal 2010, except for our revenue recognition policy, which has been updated as follows:

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

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

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

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

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

Contract revenues are derived primarily from long-term contracts with governmental agencies. Contract revenues include costs incurred plus a portion of estimated fees or profits determined using the percentage of completion method of accounting based on the relationship of costs incurred to total estimated costs. Any anticipated losses on contracts are charged to earnings when identified. Changes in job performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to recognized costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when their realization is reasonably assured. Under the percentage of completion method, recognition of profit is dependent upon the accuracy of a variety of estimates, including engineering progress, materials quantities, and achievement of milestones, incentives, penalty provisions, labor productivity, cost estimates and others. Such estimates are based on various professional judgments we make with respect to those factors and are subject to change as the project proceeds and new information becomes available.

Recent Accounting Pronouncements

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

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Results of Operations

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

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

Analysis of Quarterly Results of Operations

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

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

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

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

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

Roadway Sensors

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

Vehicle Sensors

Vehicle Sensors net sales were primarily made up of sales of our LDW systems to the heavy truck market, which aggregated approximately $1.9 million and $5.0 million for the three and nine months ended December 31, 2010, respectively, compared to $1.5 million and $3.5 million for the three and nine months ended December 31, 2009, respectively. In the prior year, we experienced a significant slowdown in overall LDW unit shipments to each of our key markets, driven largely by the weakness in the U.S. and worldwide economy at that time. Comparatively, in the current year periods, we have seen relatively higher unit sales, particularly to our foreign OEM heavy truck customers in Europe and Japan, as well as to our domestic truck fleet customers. Although we have seen improvements in our sales in the current year, as compared to the prior year, we remain cautious in our outlook for the remainder of the current fiscal year and beyond. We anticipate that Vehicle Sensors unit sales in future periods could be adversely impacted by, among other factors, slower than expected adoption rates of our LDW system across each of our target markets and the continuing uncertainty in the global economic environment. Additionally, future unit sales of LDW systems and unit pricing could be adversely impacted as a result of increased competition in this market.

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

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Contract Revenues

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

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

	Three Months Ended December 31,