

ITERIS, INC.  
Form 10-Q  
February 09, 2017  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-08762

## ITERIS, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**95-2588496**

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

**1700 Carnegie Avenue, Suite 100**

**Santa Ana, California**

(Address of principal executive office)

**92705**

(Zip Code)

**(949) 270-9400**

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the 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 Rule 12b-2 of the Exchange Act). Yes  No

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As of February 6, 2017, there were 32,239,460 shares of common stock outstanding.

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**ITERIS, INC.**

**Quarterly Report on Form 10-Q**

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Unless otherwise indicated in this report, the Company, we, us and our refer to Iteris, Inc. and its wholly-owned subsidiary. Abacus®, ClearAg®, ClearPath 511®, ClearPath Weather®, Edge®, EdgeConnect®, iPeMS®, Iteris®, Next®, P10®, P100®, PedTrax®, Pegasus®, Radius®, Reverse 511®, RZ 4®, SmartCycle®, SmartSpan®, TransitHelper®, Vantage®, VantageNext®, VantagePegasus®, VantageRadius®, Vantage Vector®, VantageView®, Velocity®, and VersiCam® are among the trademarks of Iteris, Inc. Any other trademarks or trade names mentioned herein are the property of their respective owners.



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

|   | <b>December 31,<br/>2016</b> | <b>March 31,<br/>2016</b> |
|---|------------------------------|---------------------------|
| <b>Assets</b>   |                              |                           |
| Current assets:   |                              |                           |
| Cash and cash equivalents   | \$ 17,881                    | \$ 16,029                 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$328 and \$714 at December 31, 2016 and March 31, 2016, respectively                  | 12,443                       | 13,241                    |
| Costs and estimated earnings in excess of billings on uncompleted contracts   | 6,031                        | 5,250                     |
| Inventories   | 2,753                        | 3,153                     |
| Prepaid expenses and other current assets   | 2,016                        | 1,505                     |
| Total current assets  | 41,124                       | 39,178                    |
| Property and equipment, net   | 2,078                        | 2,139                     |
| Intangible assets, net  | 1,011                        | 951                       |
| Goodwill  | 17,318                       | 17,318                    |
| Other assets  | 278                          | 434                       |
| Total assets  | \$ 61,809                    | \$ 60,020                 |
| <b>Liabilities and stockholders' equity</b>   |                              |                           |
| Current liabilities:  |                              |                           |
| Trade accounts payable  | \$ 6,809                     | \$ 5,469                  |
| Accrued payroll and related expenses  | 5,850                        | 5,719                     |
| Accrued liabilities   | 1,716                        | 1,445                     |
| Billings in excess of costs and estimated earnings on uncompleted contracts   | 2,950                        | 2,294                     |
| Total current liabilities   | 17,325                       | 14,927                    |
| Deferred rent   | 674                          | 750                       |
| Deferred income taxes   | 695                          | 685                       |
| Unrecognized tax benefits   | 210                          | 196                       |
| Total liabilities   | 18,904                       | 16,558                    |
| Commitments and contingencies (Note 7)  |                              |                           |
| Stockholders' equity:   |                              |                           |
| Preferred stock, \$1.00 par value:  |                              |                           |
| Authorized shares - 2,000 Issued and outstanding shares - none  |                              |                           |
| Common stock, \$0.10 par value:   |                              |                           |
| Authorized shares - 70,000 at December 31, 2016 and March 31, 2016 Issued and outstanding shares - 32,229 at December 31, 2016 and 32,048 at March 31, 2016 | 3,224                        | 3,205                     |
| Additional paid-in capital  | 136,306                      | 135,424                   |
| Accumulated deficit   | (96,625)                     | (95,167)                  |
| Total stockholders' equity  | 42,905                       | 43,462                    |
| Total liabilities and stockholders' equity  | \$ 61,809                    | \$ 60,020                 |

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See accompanying notes.

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## Iteris, Inc.

## Unaudited Consolidated Statements of Operations

(In thousands, except per share amounts)

|  | Three Months Ended<br>December 31, |             | Nine Months Ended<br>December 31, |             |
|--|------------------------------------|-------------|-----------------------------------|-------------|
|  | 2016                               | 2015        | 2016                              | 2015        |
| Total revenues   | \$ 22,691                          | \$ 19,014   | \$ 70,678                         | \$ 57,952   |
| Cost of revenues   | 14,071                             | 11,803      | 43,194                            | 35,220      |
| Gross profit   | 8,620                              | 7,211       | 27,484                            | 22,732      |
| Operating expenses:  |                                    |             |                                   |             |
| Selling, general and administrative                                    | 8,035                              | 6,400       | 23,698                            | 19,176      |
| Research and development   | 1,979                              | 1,853       | 5,287                             | 5,428       |
| Amortization of intangible assets                                      | 80                                 | 92          | 248                               | 276         |
| Total operating expenses   | 10,094                             | 8,345       | 29,233                            | 24,880      |
| Operating loss   | (1,474)                            | (1,134)     | (1,749)                           | (2,148)     |
| Non-operating income (expense):  |                                    |             |                                   |             |
| Other (expense) income, net  | (1)                                | (3)         | (7)                               | 1           |
| Interest income, net   | 4                                  | 3           | 9                                 | 10          |
| Loss from continuing operations before income taxes                    | (1,471)                            | (1,134)     | (1,747)                           | (2,137)     |
| Benefit (expense) for income taxes                                     | 4                                  | (9,365)     | 11                                | (9,055)     |
| Loss from continuing operations  | (1,467)                            | (10,499)    | (1,736)                           | (11,192)    |
| Gain on sale of discontinued operation, net of tax                     | 87                                 | 57          | 278                               | 163         |
| Net loss   | \$ (1,380)                         | \$ (10,442) | \$ (1,458)                        | \$ (11,029) |
| Loss per share from continuing operations - basic and diluted          | \$ (0.05)                          | \$ (0.33)   | \$ (0.05)                         | \$ (0.35)   |
| Gain per share from sale of discontinued operation - basic and diluted | \$ 0.01                            | \$ 0.00     | \$ 0.01                           | \$ 0.01     |
| Net loss per share - basic and diluted                                 | \$ (0.04)                          | \$ (0.33)   | \$ (0.04)                         | \$ (0.34)   |
| Shares used in basic and diluted per share calculations                | 32,205                             | 32,013      | 32,125                            | 32,051      |

See accompanying notes.



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## Iteris, Inc.

## Unaudited Consolidated Statements of Cash Flows

(In thousands)

|   | Nine Months Ended<br>December 31, |             |
|---|-----------------------------------|-------------|
|   | 2016                              | 2015        |
| <b>Cash flows from operating activities</b>   |                                   |             |
| Net loss  | \$ (1,458)                        | \$ (11,029) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                                   |             |
| Deferred income taxes   | 24                                | 8,874       |
| Depreciation of property and equipment  | 544                               | 482         |
| Stock-based compensation  | 718                               | 429         |
| Amortization of intangible assets   | 512                               | 400         |
| Gain on sale of discontinued operation, net of tax  | (278)                             | (163)       |
| Loss on disposal of equipment   | 14                                | 57          |
| Changes in operating assets and liabilities, net of effects of discontinued operation:    |                                   |             |
| Accounts receivable   | 798                               | (645)       |
| Net costs and estimated earnings in excess of billings                                    | (125)                             | 1,077       |
| Inventories   | 400                               | 18          |
| Prepaid expenses and other assets   | (275)                             | (396)       |
| Accounts payable and accrued expenses   | 1,500                             | (1,436)     |
| Net cash provided by (used in) operating activities                                       | 2,374                             | (2,332)     |
| <b>Cash flows from investing activities</b>   |                                   |             |
| Purchases of property and equipment   | (497)                             | (673)       |
| Capitalized software development costs  | (572)                             |             |
| Net proceeds from sale of discontinued operation  | 364                               | 284         |
| Net cash used in investing activities   | (705)                             | (389)       |
| <b>Cash flows from financing activities</b>   |                                   |             |
| Repurchases of common stock   |                                   | (1,194)     |
| Proceeds from stock option exercises  | 238                               | 367         |
| Tax withholding payments for net share settlements of restricted stock units              | (55)                              | (32)        |
| Net cash provided by (used in) financing activities                                       | 183                               | (859)       |
| Increase (decrease) in cash and cash equivalents  | 1,852                             | (3,580)     |
| Cash and cash equivalents at beginning of period  | 16,029                            | 21,961      |
| Cash and cash equivalents at end of period  | \$ 17,881                         | \$ 18,381   |
| <b>Supplemental cash flow information:</b>  |                                   |             |
| Cash paid during the quarter for:   |                                   |             |
| Interest  | \$ 14                             | \$ 10       |
| Income taxes  | 52                                | 177         |

See accompanying notes.



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**Iteris, Inc.**

**Notes to Unaudited Consolidated Financial Statements**

**December 31, 2016**

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

**Description of Business**

Iteris, Inc. (referred to collectively with its wholly-owned subsidiary, Iteris Michigan, LLC, in this report as Iteris, the Company, we, our and is a provider of intelligent information solutions for both the traffic management and global agribusiness markets. We are focused on the development and application of advanced technologies and software-based information systems that reduce traffic congestion, provide measurement, management and predictive traffic and weather analytics, and improve the safety of surface transportation systems infrastructure. By combining our unique intellectual property, products, decades of experience in traffic management, weather forecasting solutions and information technologies, we offer a broad range of Intelligent Transportation Systems ( ITS ) solutions to customers throughout the U.S. and internationally. We believe our products, services and solutions, in conjunction with sound traffic management, minimize the environmental impact of traffic congestion. In the agribusiness markets, we have combined our unique intellectual property with enhanced soil, land surface and agronomy modeling techniques to create a set of ClearAg solutions. These solutions provide analytical support to large enterprises in the agriculture market and field specific advisories to individual producers. We continue to make significant investments to leverage our existing technologies and further expand our software-based information systems to offer solutions to the precision agriculture technology markets. Iteris was incorporated in Delaware in 1987.

**Basis of Presentation**

Our unaudited consolidated financial statements include the accounts of Iteris, Inc. and its subsidiary, and have been prepared in accordance with the rules of the U.S. Securities and Exchange Commission ( SEC ) for interim reporting, which permit certain footnotes or other financial information that are normally required by generally accepted accounting principles in the United States of America ( GAAP ) to be condensed or omitted. These unaudited consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and related notes included in its Annual Report on Form 10-K for the fiscal year ended March 31, 2016 ( Fiscal 2016 ), filed with the SEC on June 20, 2016. All intercompany accounts and transactions have been eliminated in consolidation. The results of operations for the three and nine month periods ended December 31, 2016 are not necessarily indicative of the results to be expected for the fiscal year ending March 31, 2017 ( Fiscal 2017 ) or any other periods.

The results of continuing operations for all periods presented in the unaudited consolidated financial statements exclude our former vehicle sensors operation, which has been classified as a discontinued operation. See Note 3, Sale of Vehicle Sensors, for further discussion related to the discontinued operation presentation.

As of April 1, 2016, certain operations that were previously within the Agriculture and Weather Analytics segment (formerly known as our Performance Analytics segment), specifically our performance measurement and information management solution, iPeMS, and related traffic analytic consulting services, were reassigned to the Transportation Systems segment to better align our traffic analytics capabilities, resources and initiatives. All prior segment information presented in this report has been reclassified to reflect this change.

#### **Use of Estimates**

The preparation of consolidated financial statements in conformity with 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 collectability of accounts receivable and related allowance for doubtful accounts, projections of taxable income used to assess realizability of deferred tax assets, warranty reserves, costs to complete long-term contracts, indirect cost rates used in cost plus contracts, contract reserves, the valuation of purchased intangible assets and goodwill, the valuation of equity instruments and estimates of future cash flows used to assess the recoverability of long-lived assets and the impairment of goodwill and fair value of our stock option awards used to calculate the stock-based compensation.

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**Revenue Recognition**

Product revenues and related costs of sales are recognized when all of the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery under the terms of the arrangement has occurred, (iii) the price to the customer is fixed or determinable, and (iv) collection of the receivable is reasonably assured. These criteria are typically met at the time of product shipment but, in certain circumstances, may not be met until receipt or acceptance by the customer. Accordingly, at the date revenue is recognized, the significant obligations or uncertainties concerning the sale have been resolved.

Transportation Systems revenues are derived primarily from long-term contracts with governmental agencies. When appropriate, revenues are recognized using the percentage of completion method of accounting, whereby revenue is recognized as contract performance progresses and is determined based on the relationship of costs incurred to total estimated costs. Any anticipated losses on contracts are charged to earnings when identified. Changes in job performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to costs and revenues, and are recognized in the period in which the revisions are determined. Profit incentives are included in revenues, when their realization is reasonably assured. Certain of our revenues are recognized as services are performed and amounts are earned, which is measured by time incurred. Revenues accounted for in this manner generally relate to certain fixed fee professional services, cost plus fixed fee or time and materials contracts. Revenues for ongoing operations and maintenance services contracts are generally accounted for ratably as the services are performed throughout the term of the contract. Payments received in advance of services performed are deferred and recognized when the related services are performed.

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 relative selling price hierarchy permitting the use of an estimated selling price to determine the allocation of arrangement consideration to a deliverable in a multiple element arrangement where neither vendor specific objective evidence ( VSOE ) nor third party evidence ( TPE ) of fair value is available for that deliverable. In the absence of VSOE or TPE of the stand alone selling price for one or more delivered or undelivered elements in a multiple element arrangement, we are required to estimate the selling prices of those elements. Overall arrangement consideration is allocated to each element (both delivered and undelivered items) that has stand alone value based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on our estimated selling prices.

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

Costs and estimated earnings in excess of billings on uncompleted contracts in the accompanying 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 will become billable according to contract terms, which usually require the consideration of the passage of time, achievement of milestones or completion of the project.

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

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Billings in excess of costs and estimated earnings on uncompleted contracts in the accompanying 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 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 and adjustments for contract closeout settlements.

### **Concentration of Credit Risk**

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

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

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Our accounts receivable are primarily derived from billings with customers located throughout North America, as well as in the Middle East, Europe, South America and Asia. We generally do not require collateral or other security from our domestic customers. We maintain an allowance for doubtful accounts for potential credit losses, which losses have historically been within management's expectations.

We have historically had a diverse customer base. For the three and nine months ended December 31, 2016, one individual customer represented greater than 10% of our total revenues. For the three and nine months ended December 31, 2015, no individual customer represented more than 10% of our total revenues.

**Fair Values of Financial Instruments**

The fair value of cash equivalents, receivables, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity.

**Cash and Cash Equivalents**

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

**Prepaid Expenses and Other Current Assets**

Included in prepaid expenses and other current assets was approximately \$540,000 of cash designated as collateral on performance bonds, as required under certain of our Transportation Systems contracts in the Middle East. The performance bonds require us to maintain 100% cash value of the bonds as collateral in a bank that is local to the purchasing agency. The performance bond collateral is required throughout the delivery of our services and is maintained in the local bank until the contract is closed by the purchasing agency. We expect these requirements, and the related cash collateral restrictions, to remain in place through our fiscal year end March 31, 2017.

**Allowance for Doubtful Accounts**

The collectability of our accounts receivable is evaluated through review of outstanding invoices 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 accounts receivable to the amount we reasonably believe will be collected. We also maintain an allowance based on our historical collections experience. When we determine that collection is not likely, we write off accounts receivable against the allowance for doubtful accounts.

## **Inventories**

Inventories consist of finished goods, work in process and raw materials and 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**

We evaluate goodwill on an annual basis in our fourth fiscal quarter or more frequently if we believe indicators of impairment exist. We have determined that our reporting units for purposes of testing for goodwill impairment are identical to our reportable segments for financial reporting purposes. We adopted the provisions issued by the Financial Accounting Standards Board ( FASB ) that were intended to simplify goodwill impairment testing. This guidance permits us to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If we conclude that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, we conduct a two-step goodwill impairment test. The first step of the impairment test involves comparing the fair values of the applicable reporting units with their carrying values. We determine the fair values of our reporting units using the income valuation approach, as well as other generally accepted valuation methodologies. If the carrying amount of a reporting unit exceeds the reporting unit's fair value, we perform the second step of the goodwill impairment test. The second step of the goodwill impairment test involves comparing the implied fair value of the affected reporting unit's goodwill with the carrying value of that goodwill. The amount by which the carrying value of the goodwill exceeds its implied fair value, if any, is recognized as an impairment loss. We monitor the indicators for goodwill impairment testing between annual tests. As of December 31, 2016, management determined that no adjustments to the carrying value of its goodwill and intangible assets were required. However, if the Agriculture and Weather Analytics reporting unit is unable to continue signing new contracts, it is possible that the carrying values of its related assets, including goodwill, could be reduced following our annual fourth fiscal quarter impairment testing or within the next 12 months.



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We test long-lived assets and purchased intangible assets (other than goodwill) for impairment if we believe indicators of impairment exist. We determine whether the carrying value of an asset or asset group is recoverable, based on comparisons to undiscounted expected future cash flows the asset or asset group is expected to generate. If an asset is not recoverable, we record an impairment loss equal to the amount by which the carrying value of the asset exceeds its fair value. We primarily use the income valuation approach to determine the fair value of our long-lived assets and purchased intangible assets. As of December 31, 2016, there was no impairment to our long-lived and intangible assets.

**Income Taxes**

We utilize the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some or all of the deferred tax assets will not be realized, which increases our income tax expense in the period such determination is made.

Income tax positions must meet a more likely than not recognition threshold to be recognized. Income tax positions that previously failed to meet the more likely than not threshold are recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more likely than not threshold are derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

**Stock-Based Compensation**

We record stock-based compensation in our unaudited consolidated statements of operations as an expense, based on the estimated grant date fair value of our stock-based awards, whereby such fair values are amortized over the requisite service period. Our stock-based awards are currently comprised of common stock options and restricted stock units. The fair value of our common stock option awards is estimated on the grant date using the Black Scholes Merton option pricing formula. While utilizing this model meets established requirements, the estimated fair values generated by it may not be indicative of the actual fair values of our common stock option awards as it does not consider certain factors important to those awards to employees, such as continued employment and periodic vesting requirements, as well as limited transferability. The fair value of our restricted stock units is based on the closing market price of our common stock on the grant date. If there are any modifications or cancellations of the underlying unvested stock-based awards, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense.

**Research and Development Expenditures**

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

**Shipping and Handling Costs**

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

### **Sales Taxes**

Sales taxes are presented on a net basis (excluded from revenues) in the consolidated unaudited 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 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 reserve is included within accrued liabilities in the accompanying unaudited consolidated balance sheets.

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**Recent Accounting Pronouncements**

In May 2014, the FASB issued Accounting Standards Update ( ASU ) No. 2014-09, *Revenue from Contracts with Customers* ( ASU 2014-09 ), which establishes principles for reporting revenue and cash flows arising from an entity's contracts with customers. This new revenue recognition standard will replace most of the recognition guidance within GAAP. This guidance was deferred by ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, issued by the FASB in August 2015, and is now effective for fiscal years beginning on or after December 15, 2017 with early adoption permitted as of the original effective date. In March 2016, the FASB issued ASU No. 2016-08, *Revenue from Contracts with Customers: Principal versus Agent Considerations*, which further clarifies the implementation guidance in ASU 2014-09. In April 2016, the FASB issued ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, to expand the guidance on identifying performance obligations and licensing within ASU 2014-09. In May 2016, the FASB issued ASU 2016-12, *Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients*, which amends the guidance in the new revenue standard on collectability, noncash consideration, presentation of sales tax, and transition. The amendments are intended to address implementation issues that were raised by stakeholders and provide additional practical expedients to reduce the cost and complexity of applying the new revenue standard. These standards are effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period. We are currently evaluating the impact that these standards will have on our consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, *Simplifying the Measurement of Inventory* ( ASU 2015-11 ) to simplify the guidance on the measurement of inventory. Under the new standard, an entity should measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The standard is effective for interim and annual periods beginning after December 15, 2016. We do not anticipate a significant impact on our consolidated financial statements upon adoption of ASU 2015-11.

In November 2015, the FASB issued ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes* ( ASU 2015-17 ) to simplify the presentation of deferred taxes by requiring deferred tax assets and liabilities be classified as noncurrent on the balance sheet. ASU 2015-17 is effective for public companies for annual reporting periods beginning after December 15, 2016, and interim periods within those fiscal years. The standard may be adopted prospectively or retrospectively and early adoption is permitted. We early adopted ASU 2015-17, prospectively, in our fourth quarter of Fiscal 2016, which did not have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases* ( ASU 2016-02 ). The pronouncement requires an entity to recognize assets and liabilities for the rights and obligations created by leases on the entity's balance sheet for both finance and operating leases. For leases with a term of 12 months or less, an entity can elect to not recognize lease assets and lease liabilities and expense the lease over a straight-line basis for the term of the lease. ASU 2016-02 will require new disclosures that depict the amount, timing, and uncertainty of cash flows pertaining to an entity's leases. Companies are required to adopt the new standard using a modified retrospective approach for annual and interim periods beginning after December 15, 2018. Early adoption of ASU 2016-02 is permitted. We are currently evaluating the impact of ASU 2016-02 on our consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* ( ASU 2016-09 ), which is intended to simplify several aspects of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. The guidance will be effective for the fiscal year beginning after December 15, 2016, including interim periods within that year. We are currently evaluating the impact of ASU 2016-09 on our consolidated financial statements.

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In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* ( ASU 2016-15 ), which clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The new standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. We are currently evaluating the impact of ASU 2016-09 on our consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* ( ASU 2016-18 ), requiring restricted cash and cash equivalents to be included with cash and cash equivalents on the statement of cash flows. The new standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted. We are currently evaluating the impact of ASU 2016-18 on our consolidated financial statements.

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In December 2016, the FASB issued ASU No. 2016-19, *Technical Corrections and Improvements* ( ASU 2016-19 ), which clarifies guidance, corrects errors and makes minor improvements affecting a variety of topics in the Accounting Standards Codification. The new standard is effective upon issuance (December 14, 2016) for amendments that do not have transition guidance, with all other amendments effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, with early adoption permitted. We are currently evaluating the impact of ASU 2016-19 on our consolidated financial statements.

In December 2016, the FASB issued ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers* ( ASU 2016-20 ), which allows entities not to make quantitative disclosures about remaining performance obligations in certain cases and requires entities that use any of the new or previously existing optional exemptions to expand their qualitative disclosures. The new standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted. We are currently evaluating the impact of ASU 2016-20 on our consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment* ( ASU 2017-04 ), eliminating the second step of the goodwill impairment test, and eliminating the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment. The new standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, with early adoption permitted. We are currently evaluating the impact of ASU 2017-04 on our consolidated financial statements.

## 2. Supplemental Financial Information

### Inventories

The following table presents details of our inventories:

|                        | December 31,<br>2016 | (In thousands) | March 31,<br>2016 |
|------------------------|----------------------|----------------|-------------------|
| Materials and supplies | \$ 1,437             |                | \$ 1,754          |
| Work in process        |                      | 276            | 217               |
| Finished goods         | 1,040                |                | 1,182             |
|                        | \$ 2,753             |                | \$ 3,153          |

### Intangible Assets

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There are no indefinite lived intangible assets on our unaudited consolidated balance sheets. The following table presents details of our net intangible assets:

|  | December 31, 2016     |                          | March 31, 2016        |                          |
|--|-----------------------|--------------------------|-----------------------|--------------------------|
|  | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
|  | (In thousands)        |                          |                       |                          |
| Technology                             | \$ 1,856              | \$ (1,816)               | \$ 1,856              | \$ (1,708)               |
| Customer contracts / relationships     | 750                   | (715)                    | 750                   | (622)                    |
| Trade names and non-compete agreements | 1,110                 | (1,055)                  | 1,110                 | (1,008)                  |
| Capitalized software development costs | 1,560                 | (679)                    | 988                   | (415)                    |
| Total                                  | \$ 5,276              | \$ (4,265)               | \$ 4,704              | \$ (3,753)               |

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As of December 31, 2016, future estimated amortization expense is as follows:

| <b>Fiscal Year Ending March 31,</b> |          |
|-------------------------------------|----------|
| <b>(In thousands)</b>               |          |
| Remainder of 2017                   | \$ 124   |
| 2018                                | 449      |
| 2019                                | 370      |
| 2020                                | 68       |
| Thereafter                          | 1,011    |
|                                     | \$ 1,011 |

**Warranty Reserve Activity**

Warranty reserve was recorded as accrued liabilities in the accompanying unaudited consolidated balance sheets. The following table presents activity related to the warranty reserve:

|                                     | <b>Nine Months Ended</b> |             |
|-------------------------------------|--------------------------|-------------|
|                                     | <b>December 31,</b>      |             |
|                                     | <b>2016</b>              | <b>2015</b> |
|                                     | <b>(In thousands)</b>    |             |
| Balance at beginning of fiscal year | \$ 193                   | \$ 181      |
| Additions charged to cost of sales  | 218                      | 174         |
| Warranty claims                     | (138)                    | (159)       |
| Balance at end of period            | \$ 273                   | \$ 196      |

**Comprehensive Income**

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

**Loss Per Share**

The following table sets forth the reconciliation of weighted average common shares used in basic per share computations and weighted average common shares used in diluted per share computations in the unaudited consolidated financial statements:

| <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---------------------------|-------------|--------------------------|-------------|
| <b>December 31,</b>       |             | <b>December 31,</b>      |             |
| <b>2016</b>               | <b>2015</b> | <b>2016</b>              | <b>2015</b> |
| <b>(In thousands)</b>     |             |                          |             |

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|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Denominator:   |        |        |        |        |
| Weighted average common shares used in basic computation   | 32,205 | 32,013 | 32,125 | 32,051 |
| Dilutive stock options                                     |        |        |        |        |
| Dilutive restricted stock units                            |        |        |        |        |
| Weighted average common shares used in diluted computation | 32,205 | 32,013 | 32,125 | 32,051 |

The following instruments were excluded for purposes of calculating weighted average common share equivalents in the computation of diluted loss from continuing operations per share as their effect would have been anti-dilutive:

|                        | Three Months Ended<br>December 31, |       | Nine Months Ended<br>December 31, |       |
|------------------------|------------------------------------|-------|-----------------------------------|-------|
|                        | 2016                               | 2015  | 2016                              | 2015  |
|                        | (In thousands)                     |       |                                   |       |
| Stock options          | 3,237                              | 3,667 | 3,305                             | 3,231 |
| Restricted stock units | 136                                | 193   | 161                               | 221   |



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**3. Sale of Vehicle Sensors**

On July 29, 2011, we completed the sale (the "Asset Sale") of substantially all of our assets used in connection with our prior Vehicle Sensors segment to Bendix Commercial Vehicle Systems LLC ("Bendix"), a member of Knorr Bremse Group. In connection with the asset sale, we are entitled to additional consideration in the form of the following performance and royalty related earn-outs: Bendix is obligated to pay us an amount in cash equal to 85% of revenue associated with royalties received under our license and distribution agreements with Audiovox Electronics Corporation and Valeo Schalter and Sensoren GmbH through December 31, 2017, subject to certain reductions and limitations set forth in the asset purchase agreement. From the date of the asset sale through December 31, 2016, we received approximately \$2.0 million in connection with the royalty related earn-out provisions for a total of \$15.7 million in cash from the asset sale.

In accordance with applicable accounting guidance, we determined that the Vehicle Sensors segment, which constituted one of our operating segments at the time of the Asset Sale, qualified as a discontinued operation. For the nine months ended December 31, 2016 and 2015, we recorded a gain on sale of discontinued operation of approximately \$278,000 and \$163,000, respectively, net of tax, related to the earn-out provisions of the asset purchase agreement for the Asset Sale.

**4. 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.

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. No non-financial assets were measured at fair value during the nine months ended December 31, 2016 and 2015.

**5. Credit Facility**

We had a \$12.0 million revolving line of credit with California Bank & Trust ("CB&T"), which expired on October 1, 2016. We chose not to renew our line of credit as we do not foresee a need to utilize credit within the next twelve months. As of December 31, 2016 and 2015, no amounts were outstanding under the credit facility with CB&T.

**6. Income Taxes**

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The following table sets forth our benefit (expense) for income taxes, along with the corresponding effective tax rates:

|   | Three Months Ended<br>December 31, |            | Nine Months Ended<br>December 31, |            |
|---|------------------------------------|------------|-----------------------------------|------------|
|   | 2016                               | 2015       | 2016                              | 2015       |
|   | (In thousands, except percentages) |            |                                   |            |
| Benefit for income taxes                    | \$ 530                             | \$ 700     | \$ 652                            | \$ 1,010   |
| Change in valuation allowance               | (526)                              | (10,065)   | (641)                             | (10,065)   |
| Total benefit (expense) for<br>income taxes | \$ 4                               | \$ (9,365) | \$ 11                             | \$ (9,055) |
| Effective tax rate                          | 0.3%                               | (826.6)%   | 0.6%                              | (423.8)%   |

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.

In assessing the realizability of our deferred tax assets, we review all available positive and negative evidence, including reversal of deferred tax liabilities, potential carrybacks, projected future taxable income, tax planning strategies and recent financial performance. We have experienced a cumulative pre-tax loss over the trailing three years. As such, we consider it appropriate to continue to maintain a valuation allowance against our deferred tax assets. We will continuously reassess the appropriateness of maintaining a valuation allowance.

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**7. Commitments and Contingencies**

**Litigation and Other Contingencies**

On September 15, 2016, a stockholder class action and derivative action (captioned *Ionni v. Bergera, et al.*, Case No. 16-cv00807-RGA) was filed in the United States District Court for the District of Delaware (the Court) against certain of the Company's current and former directors and officers (the Individual Defendants) and the Company as a nominal defendant (together with the Individual Defendants, the Defendants). The complaint asserts claims for breach of fiduciary duty and unjust enrichment. Plaintiff contends that, in 2014 and 2015, the Individual Defendants caused the Company to issue purportedly false and misleading proxy statements in connection with the Company's annual meeting of stockholders in 2014 and 2015 (collectively, the Proxy Statements). In those Proxy Statements, the Company's stockholders were asked to approve amendments (the Amendments) to increase the number of shares of the Company's common stock reserved for issuance under the Iteris, Inc. 2007 Omnibus Incentive Plan (the 2007 Plan). Among other things, Plaintiff alleges that the Proxy Statements were materially false and misleading because they affirmatively represented that no person could receive more than 500,000 stock options or SARs under the 2007 Plan in any fiscal year (the Share Limit) and failed to disclose that the Compensation Committee had the discretion to approve an annual grant to a 2007 Plan participant in excess of that amount. Plaintiff contends that, in voting to approve the Amendments, the Company's stockholders were not fully informed and, therefore, the Amendments were not valid. Plaintiff seeks rescission of any stock options granted pursuant to the Amendments, including the option to purchase up to 1,350,000 shares of the Company's common stock that was granted in September 2015 to Mr. Bergera (the CEO Option) in connection with his appointment to serve as President and Chief Executive Officer of the Company.

The Individual Defendants deny that they breached their fiduciary duties and the Company believes the Amendments were properly approved and that all of the options granted pursuant to the Amendments, including the CEO Option, were valid. Nonetheless, to eliminate the burden, expense and uncertainty of the litigation, on November 8, 2016, the parties entered into a Memorandum of Understanding setting forth their agreement in principle to resolve the litigation. In consideration for a release of claims and dismissal of this litigation with prejudice, the Company agreed to submit a proposal at its 2016 Annual Meeting of Stockholders seeking stockholder approval for that portion of the CEO Option that exceeds the Share Limit (i.e., the 850,000 options above the Share Limit (the Excess Shares)). The Company submitted a proposal of the Excess Shares for approval by the Company stockholders at the 2016 Annual Meeting of Stockholders. On December 15, 2016, the Company's stockholders approved the Excess Shares.

The settlement is still subject to final approval of the Court. Pursuant to the Memorandum of Understanding, the parties thereto have agreed that the Plaintiff is entitled to an award of reasonable attorneys' fees and reimbursement of expenses in connection with this litigation. However, the parties have not had any discussions concerning the amount of such fees and expenses. The Company believes that any such fees and expenses will not be material. As a result, the Company has not accrued any amounts in connection with these legal proceedings other than the Company's ongoing attorneys' fees.

As a provider of traffic engineering services, hardware products, software and other various solutions for the traffic and agricultural industries, the Company has in the past been, and may in the future be from time to time, involved in litigation relating to claims arising out of its operations in the normal course of business. While the Company cannot accurately predict the outcome of any such litigation, the Company is not currently a party to any other legal proceeding, the outcome of which, in management's opinion, individually or in the aggregate, would have a material effect on the Company's unaudited consolidated results of operations, financial position or cash flows.

**Related Party Transaction**

We previously subleased office space to Maxxess Systems, Inc. ( Maxxess ), one of our former subsidiaries that we sold in September 2003. The sublease terminated in September 2007, at which time Maxxess owed us an aggregate of \$274,000. Maxxess executed a promissory note for such amount, which was subsequently amended and restated on July 23, 2013. The amended and restated note bears interest at a rate of 6% per annum, compounded annually, with accrued interest payable quarterly on the first business day of each calendar quarter. Maxxess continues to pay down the balance of this note by providing consulting services to Iteris, although we have previously fully reserved for amounts owed to us by Maxxess and the outstanding principal balance remains fully reserved. As of December 31, 2016, approximately \$146,000 of the original principal balance was outstanding and payable to Iteris. Maxxess is currently owned by an investor group that includes one former Iteris director, who has not been a director of Iteris since September 2013, and one existing director of Iteris, who currently owns less than 2% of Maxxess capital stock.

Table of Contents**8. Stock-Based Compensation**

We currently maintain two stock incentive plans, the 2007 Plan and the 2016 Omnibus Incentive Plan (the 2016 Plan). Of these plans, we may only grant future awards from the 2016 Plan. As of 2016 Annual Meeting of Stockholders, no future shares could be granted under the 2007 Plan. The 2016 Plan allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units (RSUs), cash incentive awards and other stock-based awards. At December 31, 2016, no awards had been granted under the 2016 Plan and there were approximately 3.4 million shares of common stock available for grant or issuance under the 2016 Plan. Total stock options vested and expected to vest were approximately 3.0 million as of December 31, 2016.

**Stock Options**

A summary of activity with respect to our stock options for the nine months ended December 31, 2016 is as follows:

|  | Number of<br>Shares<br>(In thousands) |    | Weighted<br>Average<br>Exercise<br>Price Per<br>Share |
|--|---------------------------------------|----|---|
| Options outstanding at March 31, 2016    | 3,309                                 | \$ | 2.07  |
| Granted                                  | 70                                    |    | 3.61  |
| Exercised                                | (130)                                 |    | 1.83  |
| Forfeited                                | (20)                                  |    | 1.85  |
| Expired                                  | (13)                                  |    | 2   |
| Options outstanding at December 31, 2016 | 3,216                                 | \$ | 2.12  |

**Restricted Stock Units**

A summary of activity with respect to our RSUs, which entitle the holder to receive one share of our common stock for each RSU upon vesting, for the nine months ended December 31, 2016 is as follows:

|                                       | Number of<br>Shares<br>(In thousands) |
|---------------------------------------|---------------------------------------|
| RSUs outstanding at March 31, 2016    | 173                                   |
| Granted                               | 3                                     |
| Vested                                | (68)                                  |
| Forfeited                             | (14)                                  |
| RSUs outstanding at December 31, 2016 | 94                                    |

**Stock-Based Compensation Expense**

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

|   | Three Months Ended<br>December 31, |        | Nine Months Ended<br>December 31, |        |
|---|------------------------------------|--------|-----------------------------------|--------|
|   | 2016                               | 2015   | 2016                              | 2015   |
|   | (In thousands)                     |        |                                   |        |
| Cost of revenues                            | \$ 15                              | \$ 13  | \$ 37                             | \$ 31  |
| Selling, general and administrative expense | 198                                | 205    | 631                               | 363    |
| Research and development expense            | 19                                 | 15     | 50                                | 35     |
| Total stock-based compensation expense      | \$ 232                             | \$ 233 | \$ 718                            | \$ 429 |

At December 31, 2016, there was approximately \$1.5 million and \$151,000 of unrecognized compensation expense related to unvested stock options and RSUs, respectively. This expense is currently expected to be recognized over a weighted average period of approximately 2.5 years for stock options and 2.1 years for RSUs.

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**9. Stock Repurchase Program**

In August 2011, our Board of Directors approved a stock repurchase program pursuant to which we were authorized to acquire up to \$3.0 million of our outstanding common stock from time to time through August 2012. We repurchased approximately 964,000 shares under this original program for a total purchase price of \$1.3 million. On August 9, 2012, our Board of Directors approved a new stock repurchase program pursuant to which we may acquire up to \$3.0 million of our outstanding common stock for an unspecified length of time. Under the new program, we may repurchase shares from time to time in open market and privately negotiated transactions and block trades, and may also repurchase shares pursuant to a 10b5-1 trading plan during our closed trading windows. There is no guarantee as to the exact number of shares that will be repurchased. We may modify or terminate the repurchase program at any time without prior notice. On November 6, 2014, our Board of Directors approved a \$3.0 million increase to our existing stock repurchase program, pursuant to which we may continue to acquire shares of its outstanding common stock from time to time for an unspecified length of time. For the three and nine months ended December 31, 2016, we did not repurchase any shares. During the three months ended December 31, 2015, we did not repurchase any shares, and during the nine months ended December 31, 2015, we repurchased approximately 656,000 shares of our common stock. As of December 31, 2016, approximately \$1.7 million remained available for the repurchase of our common stock under our current stock purchase program. From inception of the program in August 2011 through March 31, 2016, we repurchased approximately 3,422,000 shares of our common stock for an aggregate price of approximately \$5.6 million, at an average price per share of \$1.63. As of December 31, 2016, all repurchased shares have been retired and resumed their status as authorized and unissued shares of our common stock.

**10. Business Segment Information**

We currently operate in three reportable segments: Roadway Sensors, Transportation Systems, and Agriculture and Weather Analytics (formerly known as Performance Analytics).

The Roadway Sensors segment provides hardware and software products to multiple segments of the ITS market. These products primarily consist of various vehicle detection and information systems are used for traffic intersection control, communication and roadway traffic data collection applications. These include, among other products, our Vantage, VantageNext, VersiCam, Vantage Vector, SmartCycle, PedTrax, SmartSpan, Pegasus, Velocity, P10 and P100 products.

The Transportation Systems segment includes transportation engineering and consulting services, and the development of transportation management and traveler information systems for the ITS industry. As of April 1, 2016, our performance measurement and information management solution, iPeMS, and related traffic analytic consulting services, previously included in Agriculture and Weather segment, were reassigned to the Transportation Systems segment to better align our traffic analytics capabilities, resources and initiatives. Prior segment information has been reclassified to reflect this change.

The Agriculture and Weather Analytics segment includes ClearPath Weather, our road-maintenance applications, and ClearAg, our precision agriculture solutions. ClearPath Weather provides winter road maintenance recommendations for state agencies, municipalities and for commercial companies. Our ClearAg platform provides access to a comprehensive database of weather, soil and agronomic information essential to making informed agricultural decisions.

The accounting policies of our reportable segments are the same as those described in the summary of significant accounting policies (Note 1). Certain corporate general and administrative expenses, including general overhead functions such as information systems, accounting, human resources, marketing, compliance costs and certain administrative expenses, as well as 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 reported segment revenues are derived from external customers. Our Chief Executive Officer, who is our chief operating decision maker ( CODM ), reviews financial information at the operating segment level. Our CODM does not review assets by segment in his resource allocation, and therefore assets by segment are not disclosed below.



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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, 2016 and 2015:

|   | Roadway<br>Sensors | Transportation<br>Systems | Agriculture<br>and Weather<br>Analytics | Total     |
|---|--------------------|---------------------------|---|-----------|
|   | (In thousands)     |                           |   |           |
| <b>Three Months Ended December, 2016</b>    |                    |                           |   |           |
| Revenues                                    | \$ 9,397           | \$ 11,913                 | \$ 1,381                                | \$ 22,691 |
| Segment income (loss)                       | 1,940              | 1,920                     | (1,892)                                 | 1,968     |
| <b>Three Months Ended December 31, 2015</b> |                    |                           |   |           |
| Revenues                                    | \$ 9,771           | \$ 8,283                  | \$ 960                                  | \$ 19,014 |
| Segment income (loss)                       | 1,856              | 1,027                     | (1,546)                                 | 1,337     |
| <b>Nine Months Ended December, 2016</b>     |                    |                           |   |           |
| Revenues                                    | \$ 30,897          | \$ 36,638                 | \$ 3,143                                | \$ 70,678 |
| Segment income (loss)                       | 6,897              | 6,813                     | (5,582)                                 | 8,128     |
| <b>Nine Months Ended December 31, 2015</b>  |                    |                           |   |           |
| Revenues                                    | \$ 31,235          | \$ 24,536                 | \$ 2,181                                | \$ 57,952 |
| Segment income (loss)                       | 7,053              | 3,074                     | (4,904)                                 | 5,223     |

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

|  | Three Months Ended<br>December 31, |            | Nine Months Ended<br>December 31, |            |
|--|------------------------------------|------------|-----------------------------------|------------|
|  | 2016                               | 2015       | 2016                              | 2015       |
|  | (In thousands)                     |            |                                   |            |
| <b>Segment income:</b>                                 |                                    |            |                                   |            |
| Total income from reportable segments                  | \$ 1,968                           | \$ 1,337   | \$ 8,128                          | \$ 5,223   |
| <b>Unallocated amounts:</b>                            |                                    |            |                                   |            |
| Corporate and other expenses                           | (3,362)                            | (2,379)    | (9,629)                           | (7,095)    |
| Amortization of intangible assets                      | (80)                               | (92)       | (248)                             | (276)      |
| Other (expense) income, net                            | (1)                                | (3)        | (7)                               | 1          |
| Interest income, net                                   | 4                                  | 3          | 9                                 | 10         |
| Loss from continuing operations before<br>income taxes | \$ (1,471)                         | \$ (1,134) | \$ (1,747)                        | \$ (2,137) |

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

*This report, including the following discussion and analysis, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that are based on our current expectations, estimates and projections about our business and our industry, and reflect management's beliefs and certain assumptions made by us based upon information available to us as of the date of this report. When used in this report and the information incorporated herein by reference, the words expect(s), feel(s), believe(s), should, will, may, anticipate(s), estimate(s), could, should, 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, profitability, capital needs, backlog and manufacturing capabilities, competition, the impact of any current or future litigation, the impact of recent accounting pronouncements, the applications for and acceptance of our products and services, the status of our facilities and product development and the market acceptance of our products, services and technologies, and valuation allowance against our deferred tax assets. 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**

**Change in Segment Information.** On April 1, 2016, certain operations that were previously within the Agriculture and Weather Analytics segment (formerly known as our Performance Analytics segment), specifically our performance measurement and information management solution, iPeMS, and related traffic analytic consulting services, were reassigned to the Transportation Systems segment to better align our traffic analytics capabilities, resources and initiatives. All prior segment information presented in this report has been reclassified to reflect this change.

**Business Outlook.** Given the current ongoing uncertainties regarding global economic conditions, as well as the macroeconomic dynamics in the U.S., we continue to remain cautious about our overall business. We believe an economic slowdown, or a reduction in various funding sources for transportation infrastructure projects and initiatives, would adversely impact our financial results and may impair our ability to accurately forecast our future financial performance and other business trends. In addition, since the end users of a majority of our products and services are currently governmental entities, we have been, and may continue to be, negatively affected by budgetary issues and delays in purchasing decisions that many municipalities and other state and local agencies continue to face. Spending for new roadways, new systems to address traffic congestion and other transportation infrastructure improvements has been delayed or eliminated in some instances. However, we believe the need to rebuild and

modernize aging transportation infrastructure will continue, and various funding mechanisms exist to support transportation infrastructure and related projects. These include the federal highway bill, bonds, dedicated sales and gas tax measures and other alternative funding sources. Furthermore, through investments in research, development, sales, and marketing, we are entering into new commercial markets, in particular the agriculture industry, offering our ClearAg precision agriculture solutions, and we expect positive market acceptance to continue in upcoming quarters.

#### **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 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 revenue recognition, the collectability 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.

Table of Contents**Recent Accounting Pronouncements**

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

**Results of Operations**

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

|   | Three Months Ended<br>December 31, |         | Nine Months Ended<br>December 31, |         |
|---|------------------------------------|---------|-----------------------------------|---------|
|   | 2016                               | 2015    | 2016                              | 2015    |
| Total revenues                                      | 100.0%                             | 100.0%  | 100.0%                            | 100.0%  |
| Cost of revenues                                    | 62.0                               | 62.1    | 61.1                              | 60.8    |
| Gross profit  | 38.0%                              | 37.9%   | 38.9%                             | 39.2%   |
| Operating expenses:                                 |                                    |         |                                   |         |
| Selling, general and administrative                 | 35.4                               | 33.7    | 33.5                              | 33.0    |
| Research and development                            | 8.7                                | 9.7     | 7.5                               | 9.4     |
| Amortization of intangible assets                   | 0.4                                | 0.5     | 0.4                               | 0.5     |
| Total operating expenses                            | 44.5                               | 43.9    | 41.4                              | 42.9    |
| Operating loss                                      | (6.5)                              | (6.0)   | (2.5)                             | (3.7)   |
| Non-operating income (expense):                     |                                    |         |                                   |         |
| Other (expense) income, net                         | (0.0)                              | (0.0)   | (0.0)                             | 0.0     |
| Interest income, net                                | 0.0                                | 0.0     | 0.0                               | 0.0     |
| Loss from continuing operations before income taxes | (6.5)                              | (6.0)   | (2.5)                             | (3.7)   |
| Benefit (expense) for income taxes                  | 0.0                                | (49.2)  | 0.0                               | (15.6)  |
| Loss from continuing operations                     | (6.5)                              | (55.2)  | (2.5)                             | (19.3)  |
| Gain on sale of discontinued operation, net of tax  | 0.4                                | 0.3     | 0.4                               | 0.3     |
| Net loss  | (6.1)%                             | (54.9)% | (2.1)%                            | (19.0)% |

**Analysis of Quarterly Results of Operations**

**Total Revenues.** Total revenues are comprised of sales from our Roadway Sensors, Transportation Systems and Agriculture and Weather Analytics segments.

The following tables present our total revenues for the three and nine months ended December 31, 2016 and 2015:

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|                | Three Months Ended<br>December 31, |           | \$<br>Increase | %<br>Change |
|----------------|------------------------------------|-----------|----------------|-------------|
|                | 2016                               | 2015      |                |             |
|                | (In thousands, except percentages) |           |                |             |
| Total revenues | \$ 22,691                          | \$ 19,014 | \$ 3,677       | 19.3%       |

|                | Nine Months Ended<br>December 31,  |           | \$<br>Increase | %<br>Change |
|----------------|------------------------------------|-----------|----------------|-------------|
|                | 2016                               | 2015      |                |             |
|                | (In thousands, except percentages) |           |                |             |
| Total revenues | \$ 70,678                          | \$ 57,952 | \$ 12,726      | 22.0%       |

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Total revenues for the three months ended December 31, 2016 increased approximately 19.3% to \$22.7 million, compared to \$19.0 million in the corresponding period in the prior year. The increase in revenues was primarily due to an approximate 44% increase in Transportation Systems revenues and an approximate 44% increase in Agriculture and Weather Analytics revenues, offset by an approximate 4% decrease in Roadway Sensors revenues.

Total revenues for the nine months ended December 31, 2016 increased approximately 22.0% to \$70.7 million, compared to \$57.9 million in the corresponding period in the prior year. The increase in revenues was primarily due to an approximate 49% increase in Transportation Systems revenues and an approximate 44% increase in Agriculture and Weather Analytics revenues, offset by an approximate 1% decrease in Roadway Sensors revenues.

Roadway Sensors revenues for the three and nine months ended December 31, 2016 were approximately \$9.4 million and \$30.9 million, respectively, reflecting a decrease of approximately \$374,000 and \$338,000, respectively, compared to the corresponding prior year periods. The decreases in Roadway Sensors revenues during the three and nine months ended December 31, 2016 was primarily due to lower unit sales of our distribution of certain original equipment manufacturer ( OEM ) products for the traffic intersection market. During the three and nine months ended December 31, 2016, OEM sales decreased approximately \$886,000 and \$865,000, respectively, compared to the corresponding periods a year ago. While OEM products generally have lower gross margins than our core video detection products, we believe the offering of OEM products can benefit sales of our core products by providing a more comprehensive suite of traffic solutions for our customers. Going forward, we plan to grow revenues by focusing on our core domestic intersection market, and refine and deliver products that address the needs of this market, primarily our Vantage processors and camera systems and our Vantage Vector video/radar hybrid sensor, as well as our SmartCycle and SmartSpan products.

Transportation Systems revenues for the three and nine months ended December 31, 2016 were approximately \$11.9 million and \$36.6 million, respectively, reflecting an increase of approximately \$3.6 million or 44% and approximately \$12.1 million or 49%, respectively, compared to the corresponding periods in the prior year. This increase was primarily due to two large contract wins during the third quarter of Fiscal 2016, which contributed significantly to the revenue growth in the current three and nine month periods. Transportation Systems added approximately \$11.8 million of new backlog during the third quarter of Fiscal 2017. Transportation Systems backlog was approximately \$54.1 million as of December 31, 2016, compared to approximately \$53.8 million as of December 31, 2015. While the aforementioned two large contracts are expected to be near completion by the third quarter of our fiscal year ending March 31, 2018, we plan to continue to pursue larger contracts that may contain significant sub-consulting content. While we believe larger contracts will contribute to overall revenue growth, the mix of sub-consulting content will likely affect the related gross profit from period to period, as revenues derived from sub-consultants generally have lower gross margins than revenues generated by our professional services.

Agriculture and Weather Analytics revenues for the three and nine months ended December 31, 2016 were approximately \$1.4 million, and \$3.1 million, respectively, reflecting increases of approximately \$421,000 or 44% and \$962,000 or 44%, respectively, compared to the corresponding periods in the prior year. The increase was primarily due to increases in both ClearPath Weather and ClearAg solutions under newly signed contracts during Fiscal 2016 and Fiscal 2017. Going forward, we plan to continue investing in this segment, particularly in the research and development and sales and marketing of the ClearAg and ClearPath Weather solutions. We also plan to pursue commercial opportunities in the precision agriculture technology markets by offering software applications, content, and modeling services that provide analytics and decision support services that leverage our precision weather, soil and agronomic content and applications.

**Gross Profit.** The following tables present details of our gross profit for the three and nine months ended December 31, 2016 and 2015:

|                                       | <b>Three Months Ended<br/>December 31,</b> |             |                 |               |
|---------------------------------------|--|-------------|-----------------|---------------|
|                                       | <b>2016</b>                                | <b>2015</b> | <b>\$</b>       | <b>%</b>      |
|                                       | <b>(In thousands, except percentages)</b>  |             | <b>Increase</b> | <b>Change</b> |
| Gross profit                          | \$ 8,620                                   | \$ 7,211    | \$ 1,409        | 19.5%         |
| Gross profit as a % of total revenues | 38.0%                                      | 37.9%       |                 |               |

|                                       | <b>Nine Months Ended<br/>December 31,</b> |             |                 |               |
|---------------------------------------|---|-------------|-----------------|---------------|
|                                       | <b>2016</b>                               | <b>2015</b> | <b>\$</b>       | <b>%</b>      |
|                                       | <b>(In thousands, except percentages)</b> |             | <b>Increase</b> | <b>Change</b> |
| Gross profit                          | \$ 27,484                                 | \$ 22,732   | \$ 4,752        | 20.9%         |
| Gross profit as a % of total revenues | 38.9%                                     | 39.2%       |                 |               |

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Our gross profit as a percentage of total revenues increased approximately 10 basis points for the three months ended December 31, 2016 as compared to the corresponding period in the prior year, primarily due to an increase in Roadway Sensors gross profit percentage. Roadway Sensors gross profit percentage increased from approximately 44% for the three months ended December 31, 2015, to approximately 47% for the three months ended December 31, 2016, which reflected lower OEM sales in the current quarter, which generally carry lower margin than the other Roadway Sensor products. Our gross profit as a percentage of total revenues decreased approximately 30 basis points for the nine months ended December 31, 2016 as compared to the corresponding period in the prior year, primarily as a result of the revenue mix between the Roadway Sensors and Transportation Systems segments. Transportation Systems revenues increased from approximately 42% of total Company revenues for the nine months ended December 31, 2015, to approximately 52% of total Company revenues for the nine months ended December 31, 2016. Roadway Sensors revenue decreased as a percentage of total Company revenues from approximately 54% for the nine months ended December 31, 2015, to approximately 44% for the nine months ended December 31, 2016. Roadway Sensors revenues generally yield higher gross margins than our other segments.

Roadway Sensors gross profit can fluctuate in any specific quarter or year based on, among other factors, customer and product mix, competitive pricing requirements, product warranty costs and provisions for excess and obsolete inventories, as well as shifts of engineering resources from development activities to sustaining activities, which we record as cost of goods sold.

We recognize a portion of our Transportation Systems and Agriculture and Weather Analytics 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. For the Transportation Systems segment, we expect to experience gross profit variability in future periods due to our contract mix and the amount of related sub-consulting content of such contracts, as well as factors such as our ability to efficiently utilize our internal workforce, which could cause fluctuations in our margins from period to period.

**Selling, General and Administrative Expense.** The following tables present selling, general and administrative expense for the three and nine months ended December 31, 2016 and 2015:

|                                     | Three Months Ended<br>December 31, 2016 |                  | Three Months Ended<br>December 31, 2015 |                  | \$<br>Increase<br>(Decrease) | %<br>Change |
|-------------------------------------|---|------------------|---|------------------|------------------------------|-------------|
|                                     | Amount                                  | % of<br>Revenues | Amount                                  | % of<br>Revenues |                              |             |
| (In thousands, except percentages)  |   |                  |   |                  |                              |             |
| Salary and personnel-related        | \$ 5,322                                | 23.5%            | \$ 4,596                                | 24.2%            | \$ 726                       | 15.8        |
| Facilities, insurance and supplies  | 925                                     | 4.1              | 641                                     | 3.4              | 284                          | 44.3        |
| Travel and conferences              | 537                                     | 2.4              | 478                                     | 2.5              | 59                           | 12.3        |
| Professional and outside services   | 1,197                                   | 5.3              | 468                                     | 2.5              | 729                          | 155.8       |
| Other                               | 54                                      | 0.2              | 217                                     | 1.1              | (163)                        | (75.1)      |
| Selling, general and administrative | \$ 8,035                                | 35.4%            | \$ 6,400                                | 33.7%            | \$ 1,635                     | 25.5        |

|  | Nine Months Ended<br>December 31, 2016 |                  | Nine Months Ended<br>December 31, 2015 |                  | \$<br>Increase<br>(Decrease) | %<br>Change |
|--|--|------------------|--|------------------|------------------------------|-------------|
|  | Amount                                 | % of<br>Revenues | Amount                                 | % of<br>Revenues |                              |             |



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(In thousands, except percentages)

|                                     |    |        |       |    |        |       |    |       |         |
|-------------------------------------|----|--------|-------|----|--------|-------|----|-------|---------|
| Salary and personnel-related        | \$ | 16,531 | 23.4% | \$ | 13,178 | 22.7% | \$ | 3,353 | 25.4    |
| Facilities, insurance and supplies  |    | 2,375  | 3.4   |    | 2,031  | 3.5   |    | 344   | 16.9    |
| Travel and conferences              |    | 1,795  | 2.5   |    | 1,510  | 2.6   |    | 285   | 18.9    |
| Professional and outside services   |    | 3,002  | 4.2   |    | 2,025  | 3.5   |    | 977   | 48.2    |
| Other                               |    | (5)    | (0.0) |    | 432    | 0.7   |    | (437) | (101.2) |
| Selling, general and administrative | \$ | 23,698 | 33.5% | \$ | 19,176 | 33.0% | \$ | 4,522 | 23.6    |

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The overall increase in selling, general and administrative expense for the three and nine months ended December 31, 2016, as compared to the corresponding period in the prior year, was primarily due to planned headcount increases in corporate headquarters general and administrative positions, as well as planned investments in Agriculture and Weather Analytics sales and marketing, including an increase in the salesforce headcount, which resulted in higher salary and personnel-related costs. The increases in general and administrative expense were also due to legal costs incurred to reach a proxy contest settlement during our second quarter of Fiscal 2017 and legal costs incurred for the recent stockholder litigation (refer to Note 7 of Notes to Unaudited Consolidated Financial Statements, included in Part I, Item 1 of this report for a discussion of the proxy contest and stockholder litigation). The increases in general and administrative were also attributable to additional costs for internal control framework to comply with Sarbanes-Oxley standards as an accelerated filer. These increases were partially offset by a reversal of certain bad debt reserves that were placed on specific accounts receivable that were collected during the nine month period ended December 31, 2016.

**Research and Development Expense.** The following tables present research and development expense for the three and nine months ended December 31, 2016 and 2015:

|   | Three Months Ended<br>December 31, 2016 |                  | Three Months Ended<br>December 31, 2015      |                  | \$<br>Increase<br>(Decrease) | %<br>Change |
|---|---|------------------|--|------------------|------------------------------|-------------|
|   | Amount                                  | % of<br>Revenues | Amount<br>(In thousands, except percentages) | % of<br>Revenues |                              |             |
| Salary and personnel-related            | \$ 1,323                                | 5.8%             | \$ 935                                       | 4.9%             | \$ 388                       | 41.5%       |
| Facilities, development and<br>supplies | 517                                     | 2.3              | 633  | 3.3              | (116)                        | (18.3)      |
| Other                                   | 139                                     | 0.6              | 285  | 1.5              | (146)                        | (51.2)      |
| Research and development                | \$ 1,979                                | 8.7%             | \$ 1,853                                     | 9.7%             | \$ 126                       | 6.8         |

|   | Nine Months Ended<br>December 31, 2016 |                  | Nine Months Ended<br>December 31, 2015       |                  | \$<br>Increase<br>(Decrease) | %<br>Change |
|---|--|------------------|--|------------------|------------------------------|-------------|
|   | Amount                                 | % of<br>Revenues | Amount<br>(In thousands, except percentages) | % of<br>Revenues |                              |             |
| Salary and personnel-related            | \$ 3,060                               | 4.3%             | \$ 2,587                                     | 4.5%             | \$ 473                       | 18.3%       |
| Facilities, development and<br>supplies | 1,736                                  | 2.5              | 1,746  | 3.0              | (10)                         | (0.6)       |
| Other                                   | 491                                    | 0.7              | 1,095  | 1.9              | (604)                        | (55.2)      |
| Research and development                | \$ 5,287                               | 7.5%             | \$ 5,428                                     | 9.4%             | \$ (141)                     | (2.6)       |

The increase in research and development expense for the three months ended December 31, 2016, compared to the corresponding period in the prior year, was primarily due to increased research and development costs in all three of our operating segments. Research and development expense for the nine months ended December 31, 2016, compared to the corresponding period in the prior year, was relatively consistent, as the Company continues to invest in research, discovery, and development.

In the Agriculture and Weather Analytics segment, we continued to invest in the development of ClearAg and ClearPath Weather solutions. ClearAg products include historical, real-time and forecast weather content, soil and crop growth

information, and other useful crop health information to provide solutions in the precision agriculture technology markets. We successfully released generally available versions of a set of ClearAg products during the first half of Fiscal 2016, as well as our iOS Mobile Application that launched in our fourth quarter of Fiscal 2016. We also released a number of generally available advisory applications during Fiscal 2017, including our Harvest Advisory and Nitrogen Advisory. Going forward, we expect to continue to invest in our Agriculture and Weather Analytics segment to enhance the ClearAg and ClearPath Weather solutions. This continued investment may result in increases in research and development costs in future periods.

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**Income Taxes.** The following table presents our benefit (expense) for income taxes for the three and nine months ended December 31, 2016 and 2015:

|  | <b>Three Months Ended<br/>December 31,</b> |             | <b>\$</b>                      | <b>%</b>      |
|--|--|-------------|--------------------------------|---------------|
|  | <b>2016</b>                                | <b>2015</b> | <b>Increase<br/>(Decrease)</b> | <b>Change</b> |
|  | <b>(In thousands, except percentages)</b>  |             |                                |               |
| Benefit for income taxes                 | \$ 530                                     | \$ 700      | \$ (170)                       |               |
| Change in valuation allowance            | (526)                                      | (10,065)    | 9,539                          |               |
| Total benefit (expense) for income taxes | \$ 4                                       | \$ (9,365)  | \$ 9,369                       | (100.0)%      |
| Effective tax rate                       | 0.3%                                       | 826.6%      |                                |               |

|  | <b>Nine Months Ended<br/>December 31,</b> |             | <b>\$</b>                      | <b>%</b>      |
|--|---|-------------|--------------------------------|---------------|
|  | <b>2016</b>                               | <b>2015</b> | <b>Increase<br/>(Decrease)</b> | <b>Change</b> |
|  | <b>(In thousands, except percentages)</b> |             |                                |               |
| Benefit for income taxes                 | \$ 652                                    | \$ 1,010    | \$ (358)                       |               |
| Change in valuation allowance            | (641)                                     | (10,065)    | 9,424                          |               |
| Total benefit (expense) for income taxes | \$ 11                                     | \$ (9,055)  | \$ 9,066                       | (100.1)%      |
| Effective tax rate                       | 0.6%                                      | 423.8%      |                                |               |

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.

In assessing the realizability of our deferred tax assets, we review all available positive and negative evidence, including reversal of deferred tax liabilities, potential carrybacks, projected future taxable income, tax planning strategies and recent financial performance. We have experienced a cumulative pre-tax loss over the trailing three years. As such, we consider it appropriate to continue to maintain a valuation allowance against our deferred tax assets. We will continuously reassess the appropriateness of maintaining a valuation allowance.

**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 our cash reserves to fund our operations, which we believe to be sufficient to fund our operations for at least the next twelve months. However, we may need or choose to raise additional capital to fund

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potential future acquisitions and our future growth. We may raise such funds by selling equity or debt securities to the public or to selected investors or by borrowing money from financial institutions. If we raise additional funds by issuing equity or convertible debt securities, our existing stockholders may experience significant dilution and any equity securities that may be issued may have rights senior to our existing stockholders. There is no assurance that we will be able to secure funding on a timely basis, on terms acceptable to us, or at all.

At December 31, 2016, we had \$23.8 million in working capital, which included \$17.9 million in cash and cash equivalents and reflected no borrowings on our line of credit, which expired on October 1, 2016 and was not renewed. This compares to working capital of \$24.3 million at March 31, 2016, which included no borrowings on our line of credit and \$16.0 million in cash and cash equivalents.

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The following table summarizes our cash flows for the nine months ended December 31, 2016 and 2015:

|  | Nine Months Ended<br>December 31, |            |
|--|-----------------------------------|------------|
|  | 2016                              | 2015       |
|  | (In thousands)                    |            |
| <b>Net cash provided by (used in):</b> |                                   |            |
| Operating activities                   | \$ 2,374                          | \$ (2,332) |
| Investing activities                   | (705)                             | (389)      |
| Financing activities                   | 183                               | (859)      |

**Operating Activities.** Cash provided by our operations for the nine months ended December 31, 2016 was primarily the result of approximately \$2.3 million of working capital provided and offset by our net loss of approximately \$1.5 million, adjusted by approximately \$1.5 million in non-cash items for deferred income taxes, depreciation, stock-based compensation, amortization, gain on sales of discontinued operations and loss on disposal of equipment.

Cash used in our operations for the nine months ended December 31, 2015 was primarily the result of approximately \$1.4 million used in working capital and our net loss of approximately \$11.0 million, adjusted by approximately \$10.1 million in non-cash items for deferred income taxes, depreciation, amortization, stock-based compensation expense, gain on the sale of discontinued operation and loss on disposal of property and equipment.

**Investing Activities.** Net cash used in our investing activities during the nine months ended December 31, 2016 was primarily the result of approximately \$497,000 for purchases of property and equipment, and approximately \$572,000 of capitalized software development in the Agriculture and Weather Analytics business segment related to ClearAg assets, which was offset by approximately \$364,000 in proceeds from the earnout provision included in the sale of the Vehicle Sensors segment. Net cash used in our investing activities during the nine months ended December 31, 2015 was the result of approximately \$673,000 for purchases of property and equipment, which was offset by approximately \$284,000 in proceeds from the sale of the Vehicle Sensors segment.

**Financing Activities.** Net cash provided by financing activities during the nine months ended December 31, 2016 was the result of approximately \$238,000 of cash proceeds from the exercises of stock options. Net cash used in financing activities during the nine months ended December 31, 2015 was the result of approximately \$1.2 million in cash used to repurchase shares of our common stock and approximately \$367,000 of cash proceeds from the exercises of stock options.

**Borrowings**

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We previously had a \$12.0 million revolving line of credit with California Bank & Trust ( CB&T ), which expired on October 1, 2016. We were obligated to pay an unused line fee of 0.15% per annum applied to the average unused portion of the revolving line of credit during the preceding month. We chose not to renew our line of credit as we do not foresee a need to utilize credit within the next twelve months, and we will avoid paying an unused line fee.

### **Off Balance Sheet Arrangements**

Other than our operating leases, we do not have any other material off balance sheet arrangements at December 31, 2016.

### **Seasonality**

We have historically experienced seasonality, particularly with respect to our Roadway Sensors segment, which adversely affects such sales in our third and fourth fiscal quarters due to a reduction in intersection construction and repairs during the winter months due to inclement weather conditions, with the third fiscal quarter generally impacted the most by inclement weather. We have also experienced seasonality, particularly with respect to our Transportation Systems segment, which adversely impacts our third fiscal quarter due to the increased number of holidays, as a result of a reduction in available billable hours during the holiday season. In addition, we have experienced seasonality related to certain ClearPath Weather services, which adversely impacts such sales in our first and second fiscal quarters, mainly because these services are generally not required during Spring and Summer when weather conditions are comparatively milder.

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

### **Interest Rate Risk**

Our exposure to interest rate risk was limited to our line of credit, which expired on October 1, 2016 and was not renewed.

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**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

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

**Changes in Internal Controls**

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

**Inherent Limitations on Internal Control**

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

**PART II. OTHER INFORMATION**



**ITEM 1. LEGAL PROCEEDINGS**

The information set forth under the heading "Litigation and Other Contingencies" in Note 7 of Notes to Unaudited Consolidated Financial Statements, included in Part I, Item 1 of this report, is incorporated herein by reference. For additional discussion of risks associated with any legal proceedings, see "Risk Factors" below.

**ITEM 1A. RISK FACTORS**

*Our business is subject to a number of risks, some of which are discussed below. Other risks are presented elsewhere in this report and in the information incorporated by reference into this report. You should consider the following risks carefully in addition to the other information contained in this report and our other filings with the SEC, including our 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.*

*Because we depend on government contracts and subcontracts, we face additional risks related to contracting with federal, state and local governments, including budgetary issues and fixed price contracts. A significant portion of our revenues are derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. We anticipate that revenue from government contracts will continue to remain a significant portion of our revenues. Government business is, in general, subject to special risks and challenges, including:*

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- delays in funding and uncertainty regarding the allocation of funds to state and local agencies from the U.S. federal government, delays in the expenditures from the federal highway bill and delays or reductions in other state and local funding dedicated for transportation and ITS projects;
- other government budgetary constraints, cut-backs, delays or reallocation of government funding, including without limitation, changes in the new administration;
- performance bond requirements;
- long purchase cycles or approval processes;
- competitive bidding and qualification requirements;
- changes in government policies and political agendas;
- milestone requirements and liquidated damage provisions for failure to meet contract milestones; and
- international conflicts or other military operations that could cause the temporary or permanent diversion of government funding from transportation or other infrastructure projects.

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

In addition, a 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 revenues in any given period. Our inability to address any of the foregoing concerns or the loss or renegotiation of any material government contract could seriously harm our business, financial condition and results of operations.

*We recently expanded our Agriculture and Weather Analytics capabilities to address a new market segment, the agricultural market, which may not broadly accept our technologies and new products.* The application of precision analytics to the agricultural market is a relatively new development that has required us to invest, and is expected to continue to require us to invest, in additional research and development and sales and marketing without any guarantee of a commensurate increase in revenues. The introduction of any new Agriculture and Weather Analytics products and services could have longer than expected sales cycles, which could adversely impact our operating results. We cannot assure you that growers or other companies in this market will perceive the value proposition of our Agriculture and Weather Analytics or that our new ClearAg products for this market, will achieve broad market acceptance in the near future or at all. If the agricultural market fails to understand the benefit of our Agriculture and Weather Analytics products or chooses not to adopt our technologies, our business, financial condition and results of operations will be adversely affected.

*Uncertainty and delays in government funding for transportation infrastructure projects and initiatives have adversely impacted our revenues.* There was uncertainty in the past few years regarding allocation of government funds for transportation projects due to delays in the passage of a federal highway bill. On December 4, 2015, the Fixing America's Surface Transportation (FAST) Act was signed into law, providing \$305 billion over five years for surface transportation projects and programs. Despite the recently enacted FAST Act, delays in the allocation of such funds, the priority of infrastructure projects and the availability of funds for ITS related projects could continue to adversely impact our revenues and overall financial performance.

*We recently entered into the software development market and may be subject to additional challenges and additional costs and delays.* We have only been in the business of software development for a few years and may experience development and technical challenges. Our business and results of operations could also be seriously harmed by any significant delays in our software development and updates. Certain of our new products have contained undetected software errors or bugs when first released by us,

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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 or our reputation, any of which could adversely affect our business and competitive position. In addition, the software development industry frequently experiences litigation concerning intellectual property disputes, which could be costly and distract our management.

*If we do not keep pace with rapid technological changes and evolving industry standards, we will not be able to remain competitive, and the demand for our products will likely decline.* Our markets are in general characterized by the following factors:

- rapid technological advances;
- downward price pressures in the marketplace as technologies mature;
- changes in customer requirements;
- additional qualification requirements related to new products or components;
- 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.

*If we are unable to develop and introduce new products and product enhancements successfully and in a cost-effective and timely manner, or are unable to achieve market acceptance of our new products, our operating results would be adversely affected.* We believe our revenue growth and future operating results will depend on our ability to complete development of new products and

enhancements, introduce these products in a timely, cost-effective manner, achieve broad market acceptance of these products and enhancements, and reduce our production costs. We cannot guarantee the success of these products, and we may not be able to introduce any new products or any enhancements to our existing products on a timely basis, or at all. In addition, the introduction of any new products could adversely affect the sales of certain of our existing products.

We believe that we must continue to make substantial investments to support ongoing research and development in order to develop new or enhanced products and software 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.

*The markets in which we operate are highly competitive and have many more established competitors than us, which could adversely affect our revenues or the market acceptance of our products.* We compete with numerous other companies in our target markets including, but not limited to, large, multi-national corporations and many smaller regional engineering firms.

We compete with existing, well-established companies and technologies in our Roadway Sensors segment, both domestically and abroad. Only a small portion of the traffic intersection market has adopted advanced above-ground detection technologies, and our future success will depend in part upon gaining broad market acceptance for such technologies. Certain technological barriers to entry make it difficult for new competitors to enter the market with competing video or other technologies; however, we are aware of new market entrants from time to time. Increased competition could result in loss of market share, price reductions and reduced gross margins, any of which could seriously harm our business, financial condition and results of operations.

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

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The markets in which our Agriculture and Weather Analytics segment operates vary from public sector customers who focus on snow and ice management for state and county roadways, to commercial sector customers who employ our environmental content and agronomic models. Our competitors include divisions of large, international weather companies as well as a variety of small providers in the road weather market. In the commercial agriculture sector, we compete with a variety of public and private entities that currently market software, agronomic analytics and weather forecast capabilities to global agribusiness.

In each of our operating segments, many of our competitors have far greater name recognition and greater financial, technological, marketing and customer service resources than we do. This may allow our competitors 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 and services than we can. Consolidations of end users, distributors and manufacturers in our target markets exacerbate this problem. As a result of the foregoing factors, we may not be able to compete effectively in our target markets and competitive pressures could adversely affect our business, financial condition and results of operations.

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

Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Litigation may also be necessary to defend against claims of infringement or invalidity by others. We have in the past, and may in the future, be subject to litigation regarding our intellectual property rights. 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. Our recent expansion into software development activities may subject us to increased possibility of litigation. Any of the foregoing 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.

*Our failure to successfully secure new contracts and renew existing contracts could reduce our revenues and profits.* Our business depends on our ability to successfully bid on new contracts and renew existing contracts with private and public sector customers. Contract proposals and negotiations are complex and frequently involve a lengthy bidding and selection process, which are affected by a number of factors, such as market conditions, financing arrangements and required governmental approvals. For example, a customer may require us to provide a surety bond or letter of credit to protect the client should we fail to perform under the terms of the contract. If negative market conditions continue, or if we fail to secure adequate financing arrangements or the required governmental approval or fail to meet other required

conditions, we may not be able to pursue particular projects, which could reduce or eliminate our profitability.

*We may be unable to attract and retain key personnel, including senior management, which could seriously harm our business.* Due to the specialized nature of our business, we are highly dependent on the continued service of our executive officers and other key management, engineering and technical personnel. The loss of any of our officers, or any of our other executives or key members of management could adversely affect our business, financial condition, or results of operations. Our success will also depend in large part upon our ability to continue to attract, retain and motivate qualified engineering and other highly skilled technical personnel. The future success of our Transportation Systems segment will depend on our ability to hire additional qualified engineers, planners and technical personnel. The future success of our Agriculture and Weather Analytics segment will depend on our ability to hire additional software developers, qualified engineers and technical personnel. Competition for qualified employees, particularly development engineers and software developers, 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.

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

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

An inability to properly and fully utilize our Transportation Systems and Agriculture and Weather Analytics workforce could have an adverse effect on our results of operations.

***If we experience declining or flat revenues and we fail to manage such declines effectively, we may be unable to execute our business plan and may experience future weaknesses in our operating results.*** Based on our business objectives, and in order to achieve future growth, we will need to continue to add additional qualified personnel, and invest in additional research and development and sales and marketing activities, which could lead to increases in our expenses and future declines in our operating results. In addition, our past expansion has placed, and future expansion is expected to place, a significant strain on our managerial, administrative, operational, financial and other resources. If we are unable to manage these activities or any revenue declines successfully, our growth, our business, our financial condition and our results of operations could continue to be adversely affected.

***We are currently not profitable on a consolidated basis and we may be unable to become profitable on a quarterly or annual basis.*** For the quarter ended December 31, 2016, we had a net loss, and we cannot assure you that we will be profitable in the future. Our ability to become profitable in future periods could be impacted by governmental budgetary constraints, government and political agendas, economic instability and other items that are not in our control. Furthermore, we rely on operating profits from certain of our business segments to fund investments in sales and marketing and research and development initiatives. We cannot assure you that our financial performance will sustain a sufficient



level to completely support those investments. 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 or increases in planned investments. As a result, we may continue to experience operating losses and net losses in the future, which would make it difficult to fund our operations and achieve our business plan, and could cause the market price of our common stock to decline.

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

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

As a smaller reporting company, for Fiscal 2016, we were exempt from the auditor attestation requirement over our internal control over financial reporting. We anticipate that we will no longer qualify as a non-accelerated filer or smaller reporting company in the fiscal year ending March 31, 2017, and accordingly, we would be required to obtain our first auditor attestation pursuant to under Section 404(b) of the Sarbanes-Oxley Act. We may not be able to complete the work required for such attestation on a timely basis and, even if we timely complete such requirements, our independent registered public accounting firm may still conclude that our internal controls over financial reporting are not effective.

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

*Our quarterly operating results fluctuate as a result of many factors. Therefore, we may fail to meet or exceed the expectations of securities analysts and investors, which could cause our stock price to decline.* Our quarterly revenues and operating results have fluctuated and are likely to continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. Factors that could affect our revenues include, among others, the following:

- delays in government contracts and funding from time to time and budgetary constraints at the federal, state and local levels;
- our ability to access stimulus funding, funding from the federal highway bill or other government funding;
- declines in new home and commercial real estate construction and related road and other infrastructure construction;
- changes in our pricing policies and the pricing policies of our suppliers and competitors, pricing concessions on volume sales, as well as increased price competition in general;
- the long lead times associated with government contracts;
- the size, timing, rescheduling or cancellation of significant customer orders;
- our ability to control costs;

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- our ability to raise additional capital;
- the mix of our products and services sold in a quarter, which has varied and is expected to continue to vary from time to time;
- seasonality due to winter weather conditions;
- seasonality with respect to revenues from our ClearPath Weather and related weather forecasting services due to the decrease in revenues generated for such services during the spring and summer time periods;
- our ability to develop, introduce, patent, market and gain market acceptance of new products, applications and product enhancements in a timely manner, or at all;
- market acceptance of the products incorporating our technologies and products;
- the introduction of new products by competitors;
- the availability and cost of components used in the manufacture of our products;
- our success in expanding and implementing our sales and marketing programs;
- the effects of technological changes in our target markets;
- the amount of our backlog at any given time;
- the nature of our government contracts;
- decrease in revenues derived from key or significant customers;

- deferrals of customer orders in anticipation of new products, applications or product enhancements;
- risks and uncertainties associated with our international business;

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- general economic and political conditions;
- international conflicts and acts of terrorism; and
- other factors beyond our control, including but not limited to, natural disasters.

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 be subject to traffic related litigation.*** The traffic industry in general is subject to litigation claims due to the nature of personal injuries that result from traffic accidents. As a provider of traffic engineering services, products and solutions, we have been, and could in the future continue to be, from time to time, subject to litigation for traffic related accidents, even if our products or services did not cause the particular accident. While we generally carry insurance against these types of claims, some claims may not be covered by insurance or the damages resulting from such litigation could exceed our insurance coverage limits. In the event that we are required to pay significant damages as a result of one or more lawsuits that are not covered by insurance or exceed our coverage limits, it could materially harm our business, financial condition or cash flows. Even defending against unsuccessful claims could cause us to incur significant expenses and result in a diversion of management's attention.

***We rely on outside suppliers that could experience supply shortages or may experience production gaps that could materially and adversely impact our sales and financial results.*** It is possible that we could experience unforeseen quality control issues or part shortages as we adjust production to meet current demand for our products. We have historically used single suppliers for certain significant components in our products, and have had to reengineer products from time to time to address obsolete components, especially in our Roadway Sensors products. Should any such delay or disruption occur, or should a key supplier discontinue operations, our future sales will likely be materially and adversely affected. Additionally, we rely heavily on select contract manufacturers to produce many of our products and do not have any long-term contracts to guarantee supply of such products. Although we believe our contract manufacturers have sufficient capacity to meet our production schedules for the foreseeable future and we believe we could find alternative contract manufacturing sources for many of our products, if necessary, we could experience a production gap if for any reason our contract manufacturers were unable to meet our production requirements and our cost of goods sold could increase, adversely affecting our margins.

***We may engage in acquisitions of companies or technologies that may require us to undertake significant capital infusions and could result in disruptions of our business and diversion of resources and management attention.*** We have completed two acquisitions since November 2011 and, in the future, we may acquire additional complementary businesses, products, and technologies.

Acquisitions may require significant capital infusions and, in general, acquisitions also involve a number of special risks, including:

- potential disruption of our ongoing business and the diversion of our resources and management's attention;
- the failure to retain or integrate key acquired personnel;
- the challenge of assimilating diverse business cultures, and the difficulties in integrating the operations, technologies and information system of the acquired companies;
- increased costs to improve managerial, operational, financial and administrative systems and to eliminate duplicative services;
- the incurrence of unforeseen obligations or liabilities;
- potential impairment of relationships with employees or customers as a result of changes in management;  
and
- increased interest expense and amortization of acquired intangible assets, as well as unanticipated accounting charges.

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

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*Our international business operations may be threatened by many factors that are outside of our control.* While we historically have had limited international sales, revenues and operations experience, we currently have three transportation systems contracts in the United Arab Emirates and have been expanding our distribution capabilities for our Roadway Systems segment internationally, particularly in Australia, New Zealand and in South America. We plan to continue to expand our international efforts, but we cannot assure you that we will be successful in such efforts. International operations subject us to various inherent risks including, among others:

- political, social and economic instability, as well as international conflicts and acts of terrorism;
- bonding requirements for certain international projects;
- longer accounts receivable payment cycles;
- import and export license requirements and restrictions of the U.S. and each other country in which we operate;
- currency fluctuations and restrictions, and our ability to repatriate currency from certain foreign regions;
- unexpected changes in regulatory requirements, tariffs and other trade barriers or restrictions;
- required compliance with existing and new foreign regulatory requirements and laws, more restrictive labor laws and obligations, including but not limited to the U.S. Foreign Corrupt Practices Act;
- difficulties in managing and staffing international operations;
- potentially adverse tax consequences; and
- reduced protection for intellectual property rights in some countries.

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

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

*We may need to raise additional capital in the future, which may not be available on terms acceptable to us, or at all.* We have historically experienced volatility in our earnings and cash flows from operations from year to year. Should the credit markets further tighten or our business declines, we may need or choose to raise additional capital to repay indebtedness, pursue acquisitions or expand our operations. Such additional capital may be raised through bank borrowings, or other debt or equity financings. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all, and such additional financing may result in further dilution to our stockholders.

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

- market acceptance of our products and product enhancements, and the overall level of sales of our products;
- our ability to control costs;
- the supply of key components for our products;
- our ability to increase revenue and net income;
- increased research and development expenses and sales and marketing expenses;
- our need to respond to technological advancements and our competitors' introductions of new products or technologies;





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- capital improvements to new and existing facilities and enhancements to our infrastructure and systems;
- potential acquisitions of businesses and product lines;
- our relationships with customers and suppliers;
- government budgets, political agendas and other funding issues, including potential delays in government contract awards;
- our ability to successfully negotiate credit arrangements with our bank and the state of the financial markets in general; and
- general economic conditions, including the effects of the economic slowdowns and international conflicts.

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

*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. From April 1, 2014 through January 24, 2017, our common stock has traded at prices as low as \$1.48 per share and as high as \$4.85 per share. The market price of our common stock could continue to fluctuate in the future in response to various factors, including, but not limited to:

- quarterly variations in operating results;
- our ability to control costs, improve cash flow and sustain profitability;

- our ability to raise additional capital;
- shortages announced by suppliers;
- announcements of technological innovations or new products or applications by our competitors, customers or us;
- transitions to new products or product enhancements;
- acquisitions of businesses, products or technologies;
- the impact of any litigation;
- changes in investor perceptions;
- government funding, political agendas and other budgetary constraints;
- changes in earnings estimates or investment recommendations by securities analysts; and
- international conflicts, political unrest and acts of terrorism.

The stock market has from time to time experienced volatility, which has often affected and may continue to affect 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.

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

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In August 2011, our Board of Directors approved a stock repurchase program pursuant to which we were authorized to acquire up to \$3.0 million of our outstanding common stock from time to time through August 2012. On August 9, 2012, our Board of Directors approved a new stock repurchase program pursuant to which we may acquire up to \$3.0 million of our outstanding common stock for an unspecified length of time. Under the new program, we may repurchase shares from time to time in open-market and privately negotiated transactions and block trades, and may also repurchase shares pursuant to an existing or future 10b5-1 trading plan to facilitate repurchases during our closed trading windows. There is no guarantee as to the exact number of shares that will be repurchased. We may modify or terminate the repurchase program at any time without prior notice. On November 6, 2014, our Board of Directors approved a \$3.0 million increase to our existing stock repurchase program, pursuant to which we may continue to acquire shares of its outstanding common stock from time to time for an unspecified length of time.

For the three and nine months ended December 31, 2016, we did not repurchase any shares. As of December 31, 2016, there was approximately \$1.7 million of remaining funds available under the stock repurchase program.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

Table of Contents**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

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

| <b>Exhibit Number</b> | <b>Description</b>  | <b>Where Located</b>      |
|-----------------------|---|---------------------------|
| 3.1                   | Restated Bylaws of Iteris, Inc. as of February 9, 2017  | <i>Filed herewith</i>     |
| 31.1                  | Certification of the Principal Executive Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i>     |
| 31.2                  | Certification of the Principal Financial Officer, as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | <i>Filed herewith</i>     |
| 32.1                  | Certification of the Chief Executive Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002     | <i>Furnished herewith</i> |
| 32.2                  | Certification of the Chief Financial Officer, as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002     | <i>Furnished herewith</i> |
| 101.INS               | XBRL Instance Document  | <i>Filed herewith</i>     |
| 101.SCH               | XBRL Taxonomy Extension Schema Document   | <i>Filed herewith</i>     |
| 101.CAL               | XBRL Taxonomy Extension Calculation Linkbase Document   | <i>Filed herewith</i>     |
| 101.LAB               | XBRL Taxonomy Extension Label Linkbase Document   | <i>Filed herewith</i>     |
| 101.PRE               | XBRL Taxonomy Extension Presentation Linkbase Document  | <i>Filed herewith</i>     |
| 101.DEF               | XBRL Taxonomy Extension Definition Linkbase Document  | <i>Filed herewith</i>     |

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**SIGNATURES**

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

Dated: February 9, 2017

ITERIS, INC.  
(Registrant)

By */s/ JOE BERGERA*  
Joe Bergera  
Chief Executive Officer  
(Principal Executive Officer)

By */s/ ANDREW C. SCHMIDT*  
Andrew C. Schmidt  
Chief Financial Officer  
(Principal Financial Officer)

Table of Contents**Exhibit Index**

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