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Emrise CORP
Form 10-Q
January 19, 2007

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U. S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended JUNE 30, 2006

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 1-10346

EMRISE CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE
(State or Other Jurisdiction of
Incorporation or Organization)

77-0226211
(I.R.S. Employer
Identification No.)

9485 HAVEN AVENUE, SUITE 100
RANCHO CUCAMONGA, CALIFORNIA 91730
(Address of Principal Executive Offices) (Zip Code)

(909) 987-9220
(Registrant's Telephone Number, Including Area Code)

NOT APPLICABLE
(Former Name, Former Address And Former Fiscal Year,
if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that 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 is a large accelerated
filer, an accelerated filer or a non-accelerated filer. See definition of
"accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange
Act):
Large Accelerated Filer ☐ Accelerated Filer ☐ Non-Accelerated Filed ☒

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

As of January 17, 2007, there were 38,081,750 shares of the issuer's

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common stock, \$0.0033 par value, outstanding.

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PART I FINANCIAL INFORMATION

| | | |
|---------|---|-----|
| ITEM 1. | FINANCIAL STATEMENTS..... | F-1 |
| | Condensed Consolidated Balance Sheets as of June 30, 2006 (unaudited) and December 31, 2005..... | F-1 |
| | Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2006 and 2005 (restated) (unaudited)..... | F-2 |
| | Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2006 and 2005 (restated) (unaudited)..... | F-3 |
| | Condensed Consolidated Statements of Stockholders' Equity for the Six Months Ended June 30, 2006 (unaudited)..... | F-4 |
| | Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2006 and 2005 (restated) (unaudited)..... | F-5 |
| | Notes to Condensed Consolidated Financial Statements (restated) (unaudited)..... | F-6 |
| ITEM 2. | MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS..... | 2 |
| ITEM 3. | QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK..... | 22 |
| ITEM 4. | CONTROLS AND PROCEDURES..... | 22 |

PART II OTHER INFORMATION

| | | |
|----------|---|----|
| ITEM 1. | LEGAL PROCEEDINGS..... | 25 |
| ITEM 1A. | RISK FACTORS..... | 25 |
| ITEM 2. | UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS..... | 25 |
| ITEM 3. | DEFAULTS UPON SENIOR SECURITIES..... | 25 |
| ITEM 4. | SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS..... | 25 |
| ITEM 5. | OTHER INFORMATION..... | 25 |
| ITEM 6. | EXHIBITS..... | 25 |
| | SIGNATURES..... | 26 |

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EMRISE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2006 AND DECEMBER 31, 2005
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

| | June 30, 2006 |
|--|----------------------|
| | ----- (unaudited) |
| ASSETS | |
| Current assets: | |
| Cash and cash equivalents | \$ 2,204 |
| Accounts receivable, net | 7,207 |
| Inventories, net | 11,547 |
| Deferred income taxes | 1,465 |
| Prepaid and other current assets | 900 |
| | ----- |
| Total current assets | 23,323 |
| Property, plant and equipment, net | 1,983 |
| Goodwill | 12,159 |
| Intangible assets other than goodwill, net of accumulated amortization of \$549 and \$350, respectively | 3,718 |
| Other assets | 522 |
| | ----- |
| | \$ 41,705 |
| | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| Current liabilities: | |
| Borrowings under lines of credit | \$ 1,550 |
| Current portion of long-term debt | 488 |
| Notes payable to stockholders, current portion | 500 |
| Accounts payable | 3,966 |
| Income taxes payable | 227 |
| Accrued expenses | 3,941 |
| Total current liabilities | 10,672 |
| Long-term debt, less current portion | 548 |
| Notes payable to stockholders, less current portion | 1,500 |
| Deferred income taxes | 1,108 |
| Other liabilities | 1,054 |
| Total liabilities | 14,882 |
| Commitments and contingencies (Notes 8 and 14) | |
| Stockholders' equity: | |
| Common stock, \$0.0033 par value. Authorized 150,000,000 shares; issued and outstanding 38,082,000 and 37,550,000, respectively | 126 |
| Additional paid-in capital | 43,335 |
| Accumulated deficit | (16,450) |
| Accumulated other comprehensive loss | (188) |
| Total stockholders' equity | 26,823 |
| | ----- |

\$ 41,705
=====

See accompanying notes to condensed consolidated financial statements.

F-1

EMRISE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
THREE AND SIX MONTHS ENDED JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| | Three Months Ended June 30, | | Six Months Ended June 30, |
|-------------------------------------|--------------------------------|----------|------------------------------|
| | 2006 | 2005 | 2006 |
| Net sales | \$ 10,817 | \$ 9,962 | \$ 21,551 |
| Cost of sales | 7,025 | 5,999 | 13,375 |
| Gross profit | 3,792 | 3,963 | 8,176 |
| Operating expenses: | | | |
| Selling, general and administrative | 3,698 | 3,447 | 7,465 |
| Engineering and product development | 892 | 604 | 1,614 |
| Loss from operations | (798) | (88) | (903) |
| Other income (expense): | | | |
| Interest expense | (93) | (94) | (217) |
| Interest income | 21 | 37 | 46 |
| Other income (expense) | (44) | 115 | (36) |
| Loss before income taxes | (914) | (30) | (1,110) |
| Income tax expense (benefit) | 96 | (51) | 222 |
| Net income (loss) | \$ (1,010) | \$ 21 | \$ (1,332) |
| Basic loss per share | \$ (0.03) | \$ 0.00 | \$ (0.04) |
| Diluted loss per share | \$ (0.03) | \$ 0.00 | \$ (0.04) |

(1) See Notes to Condensed Consolidated Financial Statements--"Note 2--Restatement of Quarterly Statements."

See accompanying notes to condensed consolidated financial statements.

F-2

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EMRISE CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME THREE MONTHS ENDED JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED) (IN THOUSANDS)

| | Three Months Ended June 30, | | Six Months Ended June 30, |
|---|--------------------------------|----------|------------------------------|
| | 2006 | 2005 | 2006 |
| Net income (loss) | \$ (1,010) | \$ 21 | \$ (1,332) |
| Other comprehensive loss: | | | |
| Foreign currency translation adjustment | 557 | (315) | 682 |
| Comprehensive loss | \$ (453) | \$ (294) | \$ (650) |

(1) See Notes to Condensed Consolidated Financial Statements--"Note 2--Restatement of Quarterly Statements."

See accompanying notes to condensed consolidated financial statements.

F-3

EMRISE CORPORATION AND SUBSIDIARIES SIX MONTHS ENDED JUNE 30, 2006 CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (UNAUDITED) (IN THOUSANDS)

| | Common Stock | | Additional | Accumulated | Other |
|-------------------------------|--------------|--------|--------------------|-------------|-------------------------|
| | Shares | Amount | Paid-In Capital | Deficit | Comprehensive Income |
| Balance at December 31, 2005 | 37,550 | \$ 124 | \$ 42,877 | \$ (15,118) | \$ |
| Stock option exercises | 181 | 1 | 97 | -- | |
| Warrant exercises | 351 | 1 | 287 | -- | |
| Stock option issuance expense | -- | -- | 59 | -- | |
| Warrants issued for services | -- | -- | 15 | -- | |
| Comprehensive loss | -- | -- | -- | (1,332) | |
| Balance at June 30, 2006 | 38,082 | \$ 126 | \$ 43,335 | \$ (16,450) | \$ |

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See accompanying notes to condensed consolidated financial statements.

F-4

EMRISE CORPORATION AND SUBSIDIARIES SIX MONTHS ENDED JUNE 30, 2006 AND 2005 (RESTATED) CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (IN THOUSANDS)

| | Six M Ended J |
|--|------------------|
| | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net loss | \$ (1,332) |
| Adjustments to reconcile net loss to cash provided used in operating activities: | |
| Depreciation and amortization | 585 |
| Provision for inventory obsolescence | 927 |
| Deferred taxes | (79) |
| Stock option expense | 59 |
| Warrants issued for services | 15 |
| Changes in operating assets and liabilities net of businesses acquired: | |
| Accounts receivable | 2,183 |
| Inventories | (2,389) |
| Prepaid and other assets | (256) |
| Accounts payable and accrued expenses | (373) |
| Cash used in operating activities | (660) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Net purchases of property, plant and equipment | (208) |
| Cash paid for acquisition of Pascall, net of cash acquired | -- |
| Acquisition related costs of Pascall | -- |
| Disposal of property, plant and equipment | 52 |
| Cash used in investing activities | (156) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Net repayments of current notes payable | (1,733) |
| Repayments of long-term debt | (210) |
| Proceeds from long-term debt | -- |
| Proceeds from issuance common stock offering | -- |
| Payments of notes to stockholders | (250) |
| Proceeds from exercise of stock options and warrants | 385 |
| Cash provided by (used in) financing activities | (1,808) |
| Effect of exchange rate changes on cash | 457 |
| Net increase (decrease) in cash and cash equivalents | (2,167) |
| Cash and cash equivalents at beginning of period | 4,371 |

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| | | |
|--|----|-------|
| Cash and cash equivalents at end of period | \$ | 2,204 |
| | | ===== |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the period for:

| | | |
|----------|----|-------|
| Interest | \$ | 164 |
| | | ===== |

| | | |
|--------------|----|-------|
| Income taxes | \$ | 54 |
| | | ===== |

- (1) See Notes to Condensed Consolidated Financial Statements--"Note 2--Restatement of Quarterly Statements."

See accompanying notes to condensed consolidated financial statements.

F-5

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION AND BUSINESS

EMRISE Corporation (the "Company"), operates through three wholly-owned subsidiaries: EMRISE Electronics Corporation ("EMRISE Electronics"), CXR Larus Corporation ("CXR Larus"), and CXR Anderson Jacobson ("CXR-AJ"). EMRISE Electronics and its subsidiaries design, develop, manufacture and market electronic components for defense, aerospace and industrial markets. CXR Larus and CXR-AJ design, develop, manufacture and market network access and transmission products and communications test equipment. CXR Larus also engages in the manufacture and sale of communication timing and synchronization products. The Company conducts its operations out of various facilities in the United States, France, the United Kingdom and Japan and organizes itself in two product line segments: electronic components and communications equipment.

BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission and therefore do not include all information and footnotes necessary for a complete presentation of the financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America.

The unaudited condensed consolidated financial statements do, however, reflect all adjustments, consisting of only normal recurring adjustments, which are, in the opinion of management, necessary to state fairly the financial position as of June 30, 2006 and the results of operations and cash flows for the related interim periods ended June 30, 2006 and 2005. However, these results are not necessarily indicative of results for any other interim period or for the year. It is suggested that the accompanying condensed consolidated financial statements be read in conjunction with the Company's audited consolidated

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financial statements included in its amended annual report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on December 15, 2006.

STOCK-BASED COMPENSATION

ADOPTION OF SFAS 123(R)

Prior to January 1, 2006, the Company accounted for its stock-based compensation plans under the recognition and measurement provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, as permitted by Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." The Company did not recognize compensation cost related to stock options granted to its employees and non-employee directors that had an exercise price equal to or above the market value of the underlying common stock on the date of grant in its condensed consolidated statement of income prior to January 1, 2006.

F-6

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), "Share-Based Payment," and related interpretations, using the modified prospective transition method. Under that method, compensation cost recognized in the quarterly period ended June 30, 2006 includes: (a) compensation cost for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted beginning January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). In accordance with the modified prospective transition method, results for prior periods have not been restated.

The Black-Scholes option-pricing model was used to estimate the option fair values. The option-pricing model requires a number of assumptions, of which the most significant are, expected stock price volatility, the expected pre-vesting forfeiture rate and the expected option term (the amount of time from the grant date until the options are exercised or expire). Expected volatility was calculated based upon actual historical stock price movements over the most recent periods ending June 30, 2006 equal to the expected option term. Expected pre-vesting forfeitures were estimated based on actual historical pre-vesting forfeitures over the most recent periods ending June 30, 2006 for the expected option term.

Prior to the adoption of SFAS No. 123(R), the Company presented any tax benefits from deductions resulting from the exercise of stock options within operating cash flows in its condensed consolidated statements of cash flow. SFAS No. 123(R) requires that the portion of benefits resulting from tax deductions in excess of recognized compensation (the "excess tax benefits") be presented as financing cash flows. There were no excess tax benefits for the three months ended June 30, 2006 and would have been presented as an operating cash inflow prior to the adoption SFAS No. 123(R) if there were any.

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In November 2005, the Financial Accounting Standards Board ("FASB"), issued FASB Staff Position FAS123(R)-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards ("FSP"). This FSP requires an entity to follow either the transition guidance for the additional-paid-in-capital pool as prescribed in SFAS No. 123(R) or the alternative transition method as described in the FSP. An entity that adopts SFAS No. 123(R) using the modified prospective method may make a one-time election to adopt the transition method described in this FSP. An entity may take up to one year from the later of its initial adoption of SFAS No. 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. This FSP became effective in November 2005. The Company is still evaluating whether it will adopt the alternative method for calculating its additional-paid-in-capital pool described in the FSP.

F-7

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

STOCK OPTIONS AS OF THE QUARTERLY PERIOD ENDED JUNE 30, 2006

The following table summarizes stock options outstanding and changes during the quarterly period ended June 30, 2006:

| | NUMBER OF SHARES | WEIGHTED AVERAGE EXERCISE PRICE |
|--|---------------------|---------------------------------------|
| | ----- | ----- |
| Options outstanding at January 1, 2006 | 2,108,000 | \$ 1.05 |
| Granted | 50,000 | \$ 1.00 |
| Exercised | (181,000) | \$ 0.54 |
| Canceled or forfeited | -- | |
| | ----- | |
| Options outstanding at June 30, 2006 | 1,977,000 | \$ 1.09 |
| | ===== | |

Stock options outstanding and currently exercisable at June 30, 2006 are as follows:

| | OPTIONS OUTSTANDING | | | OPTIONS EXERCISABLE | |
|--------------------------|-------------------------------------|---|---------------------------------------|-------------------------------------|----------------|
| | NUMBER OF OPTIONS OUTSTANDING | WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (IN YEARS) | WEIGHTED AVERAGE EXERCISE PRICE | NUMBER OF OPTIONS EXERCISABLE | EXERCISE PRICE |
| RANGE OF EXERCISE PRICES | ----- | ----- | ----- | ----- | ----- |
| \$0.20 to \$1.00 | 1,186,000 | 6.04 | \$ 0.56 | 1,090,000 | \$ 0.56 |
| \$1.01 to \$2.00 | 780,000 | 9.13 | \$ 1.87 | 705,000 | \$ 1.87 |
| \$3.01 to \$4.00 | 11,000 | 0.38 | \$ 3.13 | 11,000 | \$ 3.13 |
| | ----- | ----- | ----- | ----- | ----- |
| | 1,977,000 | 7.23 | \$ 1.09 | 1,806,000 | \$ 1.09 |
| | ===== | | | ===== | |

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Shares available for grant under the Plan as of June 30, 2006 were 365,000.

The fair value of options granted during the three months ended June 30, 2006 was \$39,000 at a weighted average per share fair value of \$0.78. The fair value was estimated as of the grant date using the Black-Scholes option pricing model with the following assumptions: no dividend yield; expected volatility of 87% in 2006, 88% to 92% in 2005, 92% to 107% in 2004 and 92% in 2003; risk-free interest rate of 3.0% to 4.25%; and average expected lives of seven years.

As a result of adopting SFAS No. 123(R) on January 1, 2006, the Company incurred \$59,000 in compensation expense during the six months ended June 30, 2006.

Total estimated unrecognized compensation cost from unvested stock options as of June 30, 2006 was approximately \$101,000, which is expected to be recognized over a weighted average period of approximately 15 months.

The total intrinsic value, or the difference between the exercise price and the market price on the date of exercise, of all options exercised during the six month period ended June 30, 2006, was approximately \$141,000. Cash received from stock options exercised during the six month period ended June 30, 2006 was \$98,000. No stock options were exercised during the three months ended June 30, 2006.

F-8

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

PRO-FORMA STOCK COMPENSATION EXPENSE FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005

For the quarterly period ended June 30, 2005, the Company applied the intrinsic value method of accounting for stock options as prescribed by APB No. 25. Since all options granted during the quarterly period ended June 30, 2005 had an exercise price equal to the closing market price of the underlying common stock on the grant date, no compensation expense was recognized. If compensation expense had been recognized based on the estimated fair value of each option granted in accordance with the provisions of SFAS No. 123, as amended, our net loss and net loss per share would have been reduced to the following pro-forma amounts (in thousands, except per share amounts):

| | Three Months Ended June 30, 2005 | Si Ende (r |
|--|--|------------------|
| | ----- | ----- |
| Net income (loss) as reported | \$ 21 | \$ |
| Deduct: Stock-based compensation expense, determined | | |

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| | | |
|--|-----------|----|
| under the fair value method | (47) | |
| Net loss, Pro forma | \$ (26) | \$ |
| Loss per share -- basic, as reported | \$ (0.00) | \$ |
| Loss per share -- diluted, as adjusted | \$ (0.00) | \$ |
| Loss per share -- basic, pro forma | \$ (0.00) | \$ |
| Loss per share --diluted, pro forma | \$ (0.00) | \$ |

Pro-forma compensation expense under SFAS No. 123, among other computational differences, does not consider potential pre-vesting forfeitures. Because of these differences, the pro-forma stock compensation expense presented above for the prior quarterly period ended June 30, 2005 under SFAS No. 123 and the stock compensation expense recognized during the current quarterly period ended June 30, 2006 under SFAS 123(R) are not directly comparable. In accordance with the modified prospective transition method of SFAS 123(R), the prior comparative quarterly results have not been restated.

F-9

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

(2) RESTATEMENT OF QUARTERLY FINANCIAL STATEMENTS

In connection with an internal investigation by the Company's Audit Committee in response to an inquiry by the staff of the Securities and Exchange Commission's Division of Enforcement, the Company has determined that during the quarter ended December 31, 2004, the Company prematurely recognized certain net sales of communications test equipment units that were not actually delivered to the customer until the first quarter of 2005 and thus did not meet all applicable revenue recognition criteria until the first quarter of 2005. The Company has determined the effect of this premature recognition of revenues on its previously issued financial statements and has restated the unaudited quarterly financial information below, reconciling the restatement adjustments for the first quarterly period in the year ended December 31, 2005. Other than the restatement of the fourth quarterly period in the year ended December 31, 2004 and the first quarterly period in the year ended December 31, 2005, the Company did not restate its quarterly financial information for any other quarterly periods for the years ended December 31, 2004 and 2005.

| Six Months Ended June 30, 2005 | As Originally Reported | Restatement Adjustments | As Restated |
|--------------------------------|---------------------------|----------------------------|-------------|
| ----- | ----- | ----- | ----- |

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(in thousands, except per share data)

| | | | | | | |
|----------------------------------|----|--------|----|-----|----|--------|
| Net sales | \$ | 17,261 | \$ | 224 | \$ | 17,485 |
| Cost of sales | | 10,186 | | 58 | | 10,244 |
| Gross profit | | 7,075 | | 166 | | 7,241 |
| Operating expenses | | 7,414 | | 13 | | 7,427 |
| Loss from operations | | (339) | | 153 | | (186) |
| Net loss | \$ | (329) | \$ | 153 | \$ | (176) |
| Basic and diluted loss per share | \$ | (0.01) | \$ | -- | \$ | (0.00) |

F-10

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

(3) EARNINGS (LOSS) PER SHARE

The following table illustrates the computation of basic and diluted earnings per share (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------------------|------------------------------|--------------------|
| | 2006 | 2005 (restated) | 2006 | 2005 (restated) |
| NUMERATOR: | | | | |
| Net income (loss) | \$ (1,010) | \$ 21 | \$ (1,332) | \$ (1,332) |
| Income (loss) attributable to common stockholders | \$ (1,010) | \$ 21 | \$ (1,332) | \$ (1,332) |
| DENOMINATOR: | | | | |
| Weighted average number of common shares outstanding during the period-basic | 38,082 | 37,385 | 37,880 | 37,000 |
| Incremental shares from assumed conversions of warrants and options | -- | 1,254 | -- | -- |
| Adjusted weighted average number of outstanding shares-diluted | 38,082 | 38,639 | 37,880 | 37,000 |
| Basic earnings (loss) per share | \$ (0.03) | \$ 0.00 | \$ (0.04) | \$ (0.04) |
| Diluted earnings (loss) per share | \$ (0.03) | \$ 0.00 | \$ (0.04) | \$ (0.04) |

F-11

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

The following table shows the common stock equivalents that were outstanding as of June 30, 2006 and 2005 but were not included in the computation of diluted earnings per share because the options' or warrants' exercise price was greater than the average market price of the common shares and, therefore, the effect would have been anti-dilutive:

| | Number of Shares | Exercise Price Per Share |
|--------------------------------------|---------------------|-----------------------------|
| | ----- | ----- |
| Anti-dilutive common stock options: | | |
| As of June 30, 2006 | 1,121,000 | \$1.00 - \$3.13 |
| As of June 30, 2005 | 1,459,000 | \$0.20 - \$3.44 |
| Anti-dilutive common stock warrants: | | |
| As of June 30, 2006 | 4,136,000 | \$1.30 - \$2.00 |
| As of June 30, 2005 | 4,606,000 | \$0.39 - \$2.00 |

(4) INVENTORIES

Inventories are summarized as follows (in thousands), net of reserves of \$4,812 and \$4,160 as of June 30, 2006 and December 31, 2005, respectively:

| | June 30, 2006 | December 31, 2005 |
|-----------------|------------------|----------------------|
| | ----- | ----- |
| Raw materials | \$ 4,985 | \$ 4,668 |
| Work-in-process | 3,589 | 2,716 |
| Finished goods | 2,973 | 2,893 |
| | ----- | ----- |
| | \$ 11,547 | \$ 10,277 |
| | ===== | ===== |

(5) REPORTABLE SEGMENTS

The Company has two reportable segments: electronic components and communications equipment. The electronic components segment operates in the United States, European and Asian markets and designs, manufactures and markets digital and rotary switches, electronic power supplies, RF and microwave components and subsystems and subsystem assemblies. The communications equipment segment also operates in the United States, European and Asian markets and designs, manufactures and distributes network access and transmission products, communications test instruments and network timing and synchronization products.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based upon profit or loss from operations before income taxes exclusive of nonrecurring gains and losses. The Company accounts for intersegment sales at prices negotiated between the individual segments.

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

The Company's reportable segments are comprised of operating entities offering the same or similar products to similar customers. Each segment is managed separately because each business has different customers and different design and manufacturing and marketing strategies.

Each segment has business units or components as described in paragraph 30 of SFAS No. 142. Each component has discrete financial information and a management structure. Following is a description of the Company's segment and component structure as of June 30, 2006:

REPORTING UNITS WITHIN ELECTRONIC COMPONENTS SEGMENT:

- o EMRISE Electronics - Rancho Cucamonga, California: Digitran Division - manufacturer of digital and rotary switches, and electronic subsystem assemblies for defense, aerospace and industrial applications.
- o EMRISE Electronics - Monrovia, California: XCEL Circuits Division - manufacturer of printed circuit boards mostly for intercompany use but with a small base of outside customers.
- o RO Associates Incorporated - Sunnyvale, California - manufacturer of standard power supplies using proprietary technology.
- o XCEL Japan Ltd. - Tokyo, Japan - reseller of Digitran switches and other third party electronic components.
- o EMRISE Electronics Ltd. - Ashford, Kent, England/Isle of Wight, England - manufacturer of power supplies and radio frequency products for defense and aerospace applications and for a broad range of applications, including in-flight entertainment systems; this reporting unit also includes XCEL Power Systems, Ltd., Belix Wound Components Ltd., Pascall Electronic (Holdings) Limited and Pascall Electronics Limited.

REPORTING UNITS WITHIN COMMUNICATIONS EQUIPMENT SEGMENT:

- o CXR Telcom division of CXR Larus - San Jose, California - manufacturer of telecommunications test equipment for the field and central office applications.
- o Larus division of CXR Larus - San Jose, California - manufacturer of telecommunications synchronous timing devices and network access equipment.
- o CXR-AJ - Abondant, France - manufacturer of network access and modem equipment.

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EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

There were no differences in the basis of segmentation or in the basis of measurement of segment profit or loss from the amounts disclosed in the Company's audited consolidated financial statements included in its amended annual report on Form 10-K. Selected financial data for each of the Company's operating segments is shown below (in thousands):

| | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 (restated) | Six Months Ended June 30, 2006 | Six Months Ended 2005 (restated) |
|----------------------------------|--|--|--------------------------------------|--|
| SALES TO EXTERNAL CUSTOMERS: | | | | |
| Electronic Components | \$ 7,920 | \$ 6,421 | \$ 15,773 | \$ |
| Communications Equipment | 2,897 | 3,541 | 5,778 | |
| Total | \$ 10,817 | \$ 9,962 | \$ 21,551 | \$ |
| INTEREST EXPENSE | | | | |
| Electronic components | \$ 40 | \$ 24 | \$ 100 | \$ |
| Communications equipment | 53 | 68 | 117 | |
| Total | \$ 93 | \$ 92 | \$ 217 | \$ |
| DEPRECIATION AND AMORTIZATION | | | | |
| Electronic components | \$ 234 | \$ 166 | \$ 423 | \$ |
| Communications equipment | 54 | 96 | 140 | |
| Total | \$ 288 | \$ 262 | \$ 563 | \$ |
| SEGMENT INCOME (LOSS) BEFORE TAX | | | | |
| Electronic components | \$ 627 | \$ 660 | \$ 1,556 | \$ |
| Communications equipment | (645) | (99) | (877) | |
| Total | \$ (18) | \$ 561 | \$ 679 | \$ |
| SEGMENT ASSETS: | | | | |
| Electronic components | \$ 24,662 | \$ 25,144 | | |
| Communications equipment | 15,275 | 16,358 | | |
| Total | \$ 39,937 | \$ 41,502 | | |

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F-14

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

The following is a reconciliation of the reportable segment revenues, profit or loss and assets to the Company's consolidated totals (in thousands):

| | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 (restated) | Six Months Ended June 30, 2006 | Six Months Ended 2005 (restated) |
|---|--|--|--------------------------------------|--|
| NET SALES: | | | | |
| Total sales for reportable segments | \$ 10,817 | \$ 9,962 | \$ 21,551 | \$ 21,551 |
| Elimination of intersegment sales | -- | -- | -- | -- |
| Total consolidated net sales | \$ 10,817 | \$ 9,962 | \$ 21,551 | \$ 21,551 |
| INCOME BEFORE INCOME TAXES | | | | |
| Total income for reportable segments | \$ (18) | \$ 561 | \$ 679 | \$ 679 |
| Unallocated amounts: | (896) | (591) | (1,789) | (1,789) |
| Net income (loss) before income taxes | \$ (914) | \$ (30) | \$ (1,110) | \$ (1,110) |
| INTEREST EXPENSE | | | | |
| Interest expense for reportable segments | \$ 93 | \$ 92 | \$ 217 | \$ 217 |
| Other interest expense | -- | 2 | -- | -- |
| Total interest expense | \$ 93 | \$ 94 | \$ 217 | \$ 217 |
| DEPRECIATION AND AMORTIZATION | | | | |
| Depreciation and amortization expense for reportable segments | \$ 288 | \$ 262 | \$ 563 | \$ 563 |
| Other depreciation and amortization expense | 11 | 14 | 22 | 22 |
| Total depreciation and amortization | \$ 299 | \$ 276 | \$ 585 | \$ 585 |
| ASSETS | | | | |
| Total assets for reportable segments | \$ 39,937 | \$ 41,502 | | |

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| | | |
|---------------------------|-----------|-----------|
| Other assets | 1,768 | 2,959 |
| | ----- | ----- |
| Total consolidated assets | \$ 41,705 | \$ 44,461 |
| | ===== | ===== |

(6) NEW ACCOUNTING PRONOUNCEMENTS

New accounting pronouncements are discussed under the heading "Impacts of New Accounting Pronouncements" in Part I, Item 2 of this report.

F-15

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

(7) INCOME TAXES

The effective tax rate for the three-month period ended June 30, 2006 was different than the 34% U.S. statutory rate primarily because of foreign taxes on foreign source income that cannot be offset by domestic tax loss carryforwards.

(8) CREDIT FACILITIES

On August 25, 2005, the Company, together with two subsidiaries, CXR Laurus and EMRISE Electronics, acting as guarantors, obtained a credit facility from Wells Fargo Bank, N.A. for the Company's U.S. operations. As guarantors, each of CXR Telcom Corporation and EMRISE Electronics is jointly and severally liable with the Company for up to \$9,000,000. This facility is effective through September 1, 2006. The credit facility has no prepayment penalty and is subject to an unused commitment fee equal to 0.25% per annum, payable quarterly based on the average daily unused amount of the line of credit described in the following paragraph.

The credit facility provides a \$9,000,000 revolving line of credit secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. Borrowings do not need to be supported by specific receivables or inventory balances unless aggregate borrowings under the line of credit exceed \$3,000,000 at any time (a "conversion event"). The bank increased this amount from \$2,000,000 to \$3,000,000 on March 28, 2006. If a conversion event occurs, the line of credit will covert into a formula-based line of credit until the borrowings are equal to or less than \$3,000,000. The formula generally provides that the outstanding borrowings under the line of credit may not exceed an aggregate of 80% of eligible accounts receivable plus 30% of the value of eligible finished goods inventory. Interest is payable monthly. The interest rate is variable and is adjusted monthly based on the prime rate. The prime rate at June 30, 2006 was 7.25%.

The credit facility is subject to various financial covenants on a consolidated basis, which were updated on November 17, 2005 as follows. The minimum debt service coverage ratio must be greater than 1.25:1.00 on a trailing four-quarter basis. "Debt service coverage ratio" is defined as net profit after taxes, plus depreciation, plus amortization, plus or minus net distributions, divided by the sum of the current portion of long-term debt plus capitalized lease payments. The current ratio must be not less than 1.50:1.00, determined as of each fiscal quarter end. "Current ratio" is defined as total current assets divided by total current liabilities. Annual net profit after taxes must be

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greater than \$500,000, determined as of each fiscal quarter end on a rolling four-quarter basis; provided that the Company may not sustain net loss after tax in any two consecutive fiscal quarters and no fiscal quarter losses to exceed \$300,000. Total liabilities divided by tangible net worth of the Company must not at any time be greater than 1.75:1.00, determined as of each fiscal quarter end. Tangible net worth of the Company must not at any time be less than \$12,000,000 measured at the end of each quarter. "Total liabilities" is defined as current liabilities plus non-current liabilities, minus subordinated debt. "Tangible net worth" is defined as stockholders' equity plus subordinated debt, minus intangible assets.

As of June 30, 2006, the Company had no outstanding balance owing under the revolving credit line, and the Company had \$3,000,000 of availability on the non-formula based portion of the credit line. As of June 30, 2006, the Company was not in compliance with the covenant of the credit facility requiring no quarterly net loss can exceed \$300,000.

F-16

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

In the event of a default and continuation of a default, Wells Fargo may accelerate the payment of the principal balance requiring the Company to pay the entire indebtedness outstanding on that date. From and after the maturity date of the note, or any earlier date that all principal owing under the note becomes due and payable by acceleration or otherwise, the outstanding principal balance will bear interest until paid in full at an increased rate per annum equal to 4% above the rate of interest in effect from time to time under the note.

The credit facility also provides for a term loan of \$150,000 secured by equipment, amortizable over 36 months at a variable rate equal to the prime rate plus 1.5%. The term loan portion of the facility had a balance of \$50,000 at June 30, 2006.

Wells Fargo Bank, N.A. has also provided the Company with credit for the purchase of new capital equipment when needed of which a balance of \$107,000 was outstanding at June 30, 2006. The interest rate is equal to the 90-day London InterBank Offered Rate ("LIBOR") (5.509% at June 30, 2006) plus 3.75% per annum. Amounts borrowed under this arrangements are amortized over 60 months from the respective dates of borrowing and are secured by the purchased equipment.

As of June 30, 2006, the Company had approximately \$142,000 of capital leases outstanding, which amount is included in long term debt in the accompanying condensed consolidated financial statements.

As of June 30, 2006, the Company's foreign subsidiaries had credit facilities, including lines of credit and term loans, with Lloyds TSB Bank PLC ("Lloyds TSB") and Lloyds TSB Commercial Finance Limited ("Lloyds") in England, IFN Finance, a subsidiary of ABN AMRO Holdings, N.V., Banc National de Paris, Societe Generale in France, and Sogelease and Johnan Shinkin Bank in Japan. At June 30, 2006, the balances outstanding under the Company's United Kingdom, France and Japan credit facilities were \$1,486,000, \$773,000 and \$24,000, respectively.

On July 8, 2005, XPS and Pascall obtained a credit facility with Lloyds.

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At the same time, the credit facility of Venture Finance PLC, a subsidiary of ABN AMRO Holdings, N.V., was terminated, and all debt to Venture Finance PLC was paid off. The Lloyds facility provides a revolving loan secured by receivables, with a maximum availability of 2,100,000 British pounds sterling (approximately U.S. \$3,813,000 based on the exchange rate in effect on June 30, 2006). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB base rate. The Lloyds TSB base rate was 4.5% at June 30, 2006. This credit facility covers a period of 24 months, expiring on July 31, 2007. The financial covenants include a 50% cap on combined export gross sales of XPS and Pascall and days sales outstanding of less than 65 days, and the funding balance is capped at 125% of XPS and Pascall combined gross sales. As of June 30, 2006, the revolving loan had an outstanding balance of \$809,000.

On August 26, 2005, XPS entered into an agreement with Lloyds for an unsecured cashflow loan of 300,000 British pounds sterling (approximately U.S. \$545,000 based on the exchange rate in effect on June 30, 2006), payable over 12 months. The loan is structured as an overadvance on the previously negotiated 2,100,000 British pounds sterling revolving loan with Lloyds, bringing the maximum aggregate commitment on the revolving loan to 2,400,000 British pounds sterling (approximately U.S. \$4,358,000 based on the exchange rate in effect on June 30, 2006). As of June 30, 2006, the revolving loan had an outstanding balance of \$809,000.

F-17

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

The unsecured cashflow loan of 300,000 British pounds sterling is payable at a rate of 25,000 British pounds sterling per month, the first payment falling due one month after initial drawdown on the revolving loan. The interest rate is variable and is adjusted monthly based on the base rate of Lloyds TSB plus 1.9%. The Lloyds TSB base rate at June 30, 2006 was 4.5%. Lloyds TSB has sole discretion to switch the details on this overadvance account if Lloyds determines that we will have difficulty in meeting the specific reductions in the overadvance account.

On August 26, 2005, EEL, a United Kingdom-based subsidiary of the Company, entered into an agreement with Lloyds TSB for an unsecured term loan for 500,000 British pounds sterling (equivalent to U.S. \$908,000 based on the exchange rate in effect on June 30, 2006). This loan is repayable in 36 consecutive monthly installments, representing principal and interest. The interest rate is variable and is adjusted daily based on the Lloyds TSB base rate plus 2.5%. The Lloyds TSB base rate at March 31, 2006 was 4.5%. The loan also includes financial covenants. EEL must maintain consolidated profit before taxation and interest paid and payable of no less than 500% of the consolidated interest paid and payable. The Company failed to comply with this covenant and received a waiver. The Company and the bank are reviewing the covenants for possible amendment. Additionally, EEL must maintain consolidated profit before taxation, depreciation, amortization of goodwill and other intangibles and interest paid and payable of no less than 300% of the consolidated principal repayments and the consolidated interest paid and payable. As of June 30, 2006, the term loan had an outstanding balance of \$677,000.

In the event of a default, Lloyds may make the loan, including any outstanding principal and interest which has accrued, repayable on demand. If

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any amount payable is not paid when due, EEL must pay an increased interest rate per annum equal to 3% above the rate of interest in effect from time to time under the note.

In April 2003, CXR-AJ obtained a credit facility from IFN Finance, a subsidiary of ABN AMRO N.V. This credit facility is for a maximum of \$1,506,000 based on the exchange rate in effect at June 30, 2006 for the conversion of euros into United States dollars. CXR-AJ also had \$66,000 of cash credit lines with several other banks and \$32,000 of term loans with another French bank outstanding as of June 30, 2006. The IFN Finance facility is secured by accounts receivable and carries an annual interest rate of 1.6% above the French "T4M" rate. At June 30, 2006, the French T4M rate was 2.6943%, and this facility had a balance of \$665,000. This facility has no financial performance covenants.

XCEL Japan Ltd., or XJL, obtained a term loan on November 29, 2002 from Johnan Shinkin Bank. The loan is amortized over five years, carries an annual fixed interest rate of 3.25% and is secured by the assets of XJL. The balances of the loan as of June 30, 2006 were \$24,000 as of June 30, 2006 for the conversion of Japanese Yen into U.S. Dollars, using the exchange rate in effect. There are no financial performance covenants applicable to this loan.

F-18

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

(9) RELATED PARTY TRANSACTIONS

On July 13, 2004, the Company issued two promissory notes to the former stockholders of Larus Corporation totaling \$3,000,000 in addition to paying cash and issuing shares of common stock and two zero interest short-term notes totaling \$887,500 that were repaid in 2004, in exchange for 100% of the common stock of Larus Corporation (see Note 11). These notes are subordinated to the Company's bank debt and are payable in 72 equal monthly payments of principal totaling \$41,667 per month plus interest at the 30-day LIBOR plus 5% with a maximum interest rate of 7% during the first two years of the term of the notes, 8% during the third and fourth years, and 9% thereafter. At June 30, 2006, the 30-day LIBOR was 4.84%.

Future maturities of notes payable to stockholders are as follows:

| Year Ending December 31, ----- | | |
|--------------------------------------|----|-----------|
| 2006 | \$ | 250,000 |
| 2007 | | 500,000 |
| 2008 | | 500,000 |
| 2009 | | 500,000 |
| 2010 | | 250,000 |
| | | ----- |
| | \$ | 2,000,000 |
| | | ===== |

Interest paid on these notes in the three months ended June 30, 2006 and 2005 was \$37,000 and \$46,000, respectively.

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There are no guarantees by officers or fees paid to officers or loans to or from officers.

(10) JANUARY 2005 PRIVATE PLACEMENT

On January 5, 2005, the Company issued to 17 accredited record holders in a private offering an aggregate of 12,503,500 shares of common stock at a purchase price of \$1.44 per share and five-year investor warrants to purchase up to an additional 3,125,875 shares of our common stock at an exercise price of \$1.73 per share, for total proceeds of approximately \$18,005,000. The Company paid cash placement agent fees and expenses of approximately \$961,000, and issued five-year placement warrants to purchase up to an aggregate of 650,310 shares of common stock at an exercise price of \$1.73 per share in connection with the offering. The total warrants issued, representing 3,776,185 shares of the Company's common stock, have an estimated value of \$4,400,000. Additional costs related to the financing include legal, accounting and consulting fees that totaled approximately \$984,000 through December 31, 2005 including liquidated damages of \$480,000 charged directly to equity as a return of capital against the gross proceeds of the financing. The Company used a portion of the proceeds from this financing to fund the acquisition of Pascall described in Note 11. The Company used the remaining proceeds from this financing for additional acquisitions and for investments in new products and enhancements to existing products.

F-19

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

(11) ACQUISITIONS

LARUS CORPORATION ACQUISITION

Pursuant to the terms of a Stock Purchase Agreement executed on July 13, 2004, the Company acquired all of the issued and outstanding common stock of Larus Corporation. Larus Corporation was based in San Jose, California and engaged in the manufacturing and sale of telecommunications products. Larus Corporation had one wholly-owned subsidiary, Vista Labs, Incorporated ("Vista"), which provided engineering services to Larus Corporation. Assets held by Larus Corporation included intellectual property, cash, accounts receivable and inventories owned by each of Larus Corporation and Vista.

The purchase price for the acquisition totaled \$6,539,500 and consisted of \$1,000,000 in cash, the issuance of 1,213,592 shares of the Company's common stock with a fair value of \$1,000,000, \$887,500 in the form of two short-term, zero interest promissory notes that were repaid in 2004, \$3,000,000 in the form of two subordinated secured promissory notes, warrants to purchase up to an aggregate of 150,000 shares of the Company's common stock at \$1.30 per share, and approximately \$580,000 of acquisition costs. The warrants to purchase 150,000 shares of common stock were valued at \$72,000 using a Black-Scholes formula that included a volatility of 107.19%, an interest rate of 3.25%, a life of three years and no assumed dividend.

In addition, the Company assumed \$245,000 in accounts payable and accrued expenses and entered into an above-market real property lease with the sellers.

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This lease represents an obligation that exceeds the fair market value by approximately \$756,000 and is part of the acquisition accounting. The cash portion of the acquisition purchase price was funded with proceeds from the Company's credit facility with Wells Fargo Bank, N.A. and cash on-hand.

In conjunction with the Company's July 2004 acquisition of Larus Corporation, the Company commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The study is complete and the intangible values are as follows: Larus trade name and trademark are valued at \$750,000 compared to the Company's initial estimate of \$2,800,000, and the technology and customer relationships are valued at \$1,350,000 as compared to the Company's initial estimate of \$800,000. Goodwill associated with the Larus Corporation acquisition totaled \$4,043,000. The Larus trade name and trademark were determined to have indefinite lives and therefore are not being amortized but rather are being periodically tested for impairment. The technology and customer relationships were both estimated to have ten-year lives and, as a result, \$162,000 of amortization expense was recorded and charged to administrative expense in 2005.

PASCALL ACQUISITION

On March 1, 2005, the Company and EEL, a second-tier wholly-owned subsidiary of the Company, entered into an agreement ("Purchase Agreement") for EMRISE Electronics to acquire all of the issued and outstanding capital stock of Pascall Electronic (Holdings) Limited ("PEHL"). The closing of the purchase occurred on March 18, 2005. The Company loaned to EEL the funds that EEL used to purchase PEHL. PEHL has one wholly-owned subsidiary, Pascall Electronics Limited ("Pascall"), which produces, designs, develops, manufactures and sells power supplies and RF products for a broad range of applications, including in-flight entertainment systems and military programs.

F-20

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

Under the Purchase Agreement, EEL purchased all of the outstanding capital stock of PEHL, using funds loaned to EEL by the Company. The purchase price for the acquisition initially totaled \$9,669,000, subject to adjustments as described below, and included a \$5,972,000 cash payment to PEHL's former parent, a \$3,082,000 loan to PEHL and Pascall and approximately \$615,000 in acquisition costs, as described below.

The initial portion of the purchase price was 3,100,000 British pounds sterling (approximately U.S. \$5,972,000 based on the exchange rate in effect on March 18, 2005). The initial portion of the purchase price was paid in cash at the closing and was subject to upward or downward adjustment on a pound for pound basis to the extent that the value of the net assets of Pascall as of the closing date was greater or less than 2,520,000 British pounds sterling.

On May 6, 2005, the Company submitted to Intelek Properties Limited (which is a subsidiary of Intelek PLC, a London Stock Exchange public limited company, and is the former parent of PEHL), the Company's calculation of the value of the net assets of Pascall as of the closing date, which the Company believed slightly exceeded 2,520,000 British pounds sterling. Ultimately, the parties determined that the value of the net assets of Pascall at the closing date was

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2,650,000 British pounds sterling. As a result, the Company paid to Intelek Properties Limited 130,000 British pounds sterling (approximately U.S. \$236,000 based on the exchange rate in effect at June 30, 2005) on August 1, 2005 to satisfy this obligation. The purchase price is also subject to downward adjustments for any payments that may be made to EEL under indemnity, tax or warranty provisions of the Purchase Agreement. EEL loaned to PEHL and Pascall at the closing 1,600,000 British pounds sterling (approximately U.S. \$3,082,000 based on the exchange rate in effect on March 18, 2005) in accordance with the terms of a Loan Agreement entered into by those entities at the closing. The loaned funds were used to immediately repay outstanding intercompany debt owed by PEHL and Pascall to the seller.

In conjunction with the acquisition of Pascall, the Company commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The Company considered whether the acquisition included various types of identifiable intangible assets, including trade names, trademarks, patents, covenants not to compete, customers, workforce, technology and software. The Company has recorded the value of the trade name and trademark at \$500,000, covenants not to compete that were obtained from Pascall's former affiliates at \$200,000, amortizable over three years and backlog at \$200,000 amortizable over two years. The Company believes that no other identifiable intangible assets of value were acquired. No patents were acquired. The Company has not ascribed any value to Pascall's customer base because the Company's United Kingdom subsidiary, XPS already was selling to Pascall's key customers. Pascall's workforce does not hold any special skills that are not readily available from other sources. The Company did not identify any valuable completed technology that was acquired, because Pascall utilizes non-proprietary technology to produce custom power supplies pursuant to customer specifications. Pascall does not develop or design software and does not own software of any material value.

F-21

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

In accordance with the valuation study and taking into consideration post-closing adjustments, the Company has recorded goodwill associated with the Pascall acquisition of \$4,634,000 compared to the initial goodwill recorded of \$4,571,000.

RO ASSOCIATES ACQUISITION

On September 2, 2005, the Company's wholly-owned subsidiary, EMRISE Electronics, entered into a stock purchase agreement dated effective as of August 31, 2005 to acquire RO Associates Incorporated, a California corporation ("RO"). Effective September 28, 2005, EMRISE Electronics entered into an amendment to the stock purchase agreement.

Pursuant to the terms of the stock purchase agreement, as amended, EMRISE Electronics acquired all of the issued and outstanding shares of common stock of RO. Prior to the acquisition, all of the common stock of RO was owned by Robert H. Okada as Trustee of the Robert H. Okada Trust Agreement dated February 11, 1992, and Sharon Vavro.

The purchase price consisted of \$2,400,000 in cash paid at closing and an

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additional \$600,000 in cash payable in two equal installments on October 6, 2005 and March 31, 2006. The acquisition purchase price was funded with cash on-hand. The purchase price was subject to adjustment based on the value of the stockholders' equity, accounts receivable, accounts payable, cash on hand and net inventory of RO, as determined by the consolidated, unaudited balance sheet as of August 31, 2005, prepared in accordance with accounting principles generally accepted in the United States of America. In addition, concurrently with the closing of the acquisition of RO, EMRISE Electronics paid in full all then existing credit facilities of RO in the aggregate amount of \$1,602,000.

In determining the purchase price for RO, EMRISE Electronics considered the historical and expected earnings and cash flow of RO, as well as the value of companies of a size and in an industry similar to RO, comparable transactions and the market for such companies generally. The purchase price represented a premium of approximately \$2,275,000 over the \$2,340,000 recorded net worth of the assets of RO. In determining this premium, EMRISE Electronics considered the synergistic and strategic advantages provided by having a United States-based power conversion manufacturer and the value of the goodwill, customer relationships and technology of RO. Goodwill associated with the RO acquisition totaled approximately \$1,376,000. The Company commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The valuation study of RO's intangibles was completed in June 2006. The Company initially estimated the intangibles to be valued as follows: technology, \$484,000, trademarks, \$300,000 and customer relationships, \$200,000. The valuation study resulted in the following valuations: technology, \$500,000, trademarks, \$350,000 and customer relationships, \$350,000. The intangibles were adjusted to the appraised values in the second quarter of 2006. The technology and customer relationships are being amortized over 10 years on their appraise values and the trademarks are not being amortized due to the inability to determine an estimated life.

F-22

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006 (UNAUDITED)

(12) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets by segment as of June 30, 2006 are as follows (in thousands):

| | Goodwill -- Not Amortizable | Trademarks and Trade Names -- Not Amortizable | Technology Acquired -- 10-Year Life Amortizable | Customer Relationships -- 10-Year Life Amortizable | Cove to C 3-Ye Amor |
|--------------------------|--------------------------------|---|--|---|------------------------------|
| | ----- | ----- | ----- | ----- | ----- |
| GROSS COST | | | | | |
| Electronic components | \$ 6,806 | \$ 850 | \$ 500 | \$ 350 | \$ |
| Communications equipment | 6,429 | 750 | 1,150 | 200 | |
| | ----- | ----- | ----- | ----- | ----- |
| Total | \$ 13,235 | \$ 1,600 | \$ 1,650 | \$ 550 | \$ |
| | ===== | ===== | ===== | ===== | ===== |

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ACCUMULATED AMORTIZATION

| | | | | | | | | | |
|--------------------------|----|-------|----|----|----|-----|----|----|----|
| Electronic components | \$ | 204 | \$ | -- | \$ | 42 | \$ | 29 | \$ |
| Communications equipment | | 872 | | -- | | 230 | | 40 | |
| | | | | | | | | | |
| Total | \$ | 1,076 | \$ | -- | \$ | 272 | \$ | 69 | \$ |
| | | | | | | | | | |

CARRYING VALUE

| | | | | | | | | | |
|--------------------------|----|--------|----|-------|----|-------|----|-----|----|
| Electronic components | \$ | 6,602 | \$ | 850 | \$ | 458 | \$ | 321 | \$ |
| Communications equipment | | 5,557 | | 750 | | 920 | | 160 | |
| | | | | | | | | | |
| Total | \$ | 12,159 | \$ | 1,600 | \$ | 1,378 | \$ | 481 | \$ |
| | | | | | | | | | |

F-23

EMRISE CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) JUNE 30, 2006 AND 2005 (RESTATED) (UNAUDITED)

Changes in goodwill by segment (in thousands):

| | Electronic Components | Communications Equipment | Total |
|---|--------------------------|-----------------------------|-----------|
| | | | |
| Balance at January 1, 2006 | \$ 6,510 | \$ 5,557 | \$ 12,067 |
| Reclassified to leasehold improvements at RO | (71) | -- | (71) |
| Revaluation of intangibles at RO | (216) | -- | (216) |
| Foreign currency translation | 379 | -- | 379 |
| | | | |
| Balance June 30, 2006 | \$ 6,602 | \$ 5,557 | \$ 12,159 |
| | | | |

(13) ACCRUED EXPENSES

Accrued expenses were as follows (in thousands):

| | June 30 2006 | December 31, 2005 |
|------------------------------------|-----------------|----------------------|
| | | |
| Accrued salaries | \$ 731 | \$ 675 |
| Accrued payroll taxes and benefits | 803 | 762 |
| Advance payments from customers | 663 | 219 |
| Other accrued expenses | 1,744 | 1,915 |
| | | |
| Total accrued expenses | \$ 3,941 | \$ 3,571 |
| | | |

(14) SUBSEQUENT EVENTS

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STOCK ISSUANCE

In May 2006, the Company determined that its recent periodic filings could not be relied upon and underwent a reaudit for the years 2003, 2004 and 2005 that had been audited previously. This matter caused the Company's S-3 filing to become no longer effective and caused the obligation of the Company under the Registration Rights Agreement to pay 1% liquidated damages to the remaining shareholders from their remaining shares still owned of the private offering. Aggregate payments in the amount of \$323,135 were made from June through December 2006. These payments were charged to administrative expenses.

EXECUTIVE MANAGEMENT

On August 18, 2006, the company's Chief Financial Officer, Randolph D. Foote, resigned from all positions with the Company and its subsidiaries, and entered into a Resignation and Separation Agreement with the Company, which became effective on August 25, 2006. Under the agreement, Mr. Foote resigned all of his positions with the Company and, the Company and Mr. Foote jointly terminated his employment agreement dated effective as of January 1, 2006. The agreement provides that effective as of August 21, 2006, Mr. Foote will be assigned to temporary employment with the Company, which the parties anticipate will terminate by approximately December 31, 2006. On December 31, 2006, the Company and Mr. Foote amended the separation agreement to extend Mr. Foote's temporary employment to March 30, 2007. During the time of his temporary employment, Mr. Foote will assist the Company in, among other things, the preparation of the Company's restated financial statements and its filings with the Securities and Exchange Commission and will continue to receive his base salary and employment benefits (other than paid vacation benefits, bonus or incentive compensation).

F-24

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

CREDIT FACILITIES

On September 19, 2006, the Company entered into a Third Amendment to Credit Agreement effective as of September 1, 2006 with Wells Fargo Bank. The amendment provided for the waiver by Wells Fargo Bank of certain violations of financial covenants in the Company's existing credit facility. The amendment also provided for the reduction in the amount of the credit facility from \$9.0 million to \$1.5 million and limited borrowings to 80% of eligible accounts receivable. In connection with the amendment, the Company executed a Revolving Line of Credit Note dated September 1, 2006 in the amount of \$1.5 million. On October 9, 2006, the Company executed a letter agreement dated effective October 1, 2006 with Wells Fargo Bank extending the maturity date of the \$1.5 million note to October 20, 2006.

On November 13, 2006, Wells Fargo Bank issued a notice of default and demand for payoff with respect to the \$1.5 million note. All obligations under the note were due and payable on November 20, 2006. On November 24, 2006, the Company entered into a Forbearance Agreement with Wells Fargo Bank, dated effective as of November 20, 2006, whereby Wells Fargo Bank agreed to forbear from exercising its rights under the credit facility as described in the notice

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of default and demand for payoff through December 1, 2006. On December 1, 2006, EMRISE Corporation, EMRISE Electronics, CXR Larus, RO and Wells Fargo Bank acting through its Wells Fargo Business Credit operating division ("WFBC") entered into a Credit and Security Agreement providing for a revolving line of credit and term loan. On December 5, 2006, the Company paid off the \$1.5 million Wells Fargo Bank credit facility in full.

The credit facility with WFBC provides for a \$5.0 million revolving line of credit that expires on December 1, 2009. If WFBC terminates the credit facility during a default period, or if the Company terminates or reduces the credit facility prior to the maturity date, or if the Company prepays the term loan portion of the facility, the Company will be subject to penalties as follows: if the termination or prepayment occurs during the one year period after the initial funding date, the penalty is equal to 3% of the maximum line amount and/or prepayment amount; if the termination or prepayment occurs during second year after the initial funding date, the penalty is equal to 2% of the maximum line amount and/or prepayment amount; and if the termination or prepayment occurs at any time after the second anniversary of the initial funding date and prior to the maturity date, the penalty is equal to 1% of the maximum line amount and/or prepayment amount. The credit facility is subject to an unused line fee equal to 0.25% per annum, payable monthly based on the average daily unused amount of the line of credit described in the following paragraph. The credit facility is also subject to a minimum monthly interest charge of \$8,500 with respect to the revolving line of credit.

The WFBC credit facility provides a \$5,000,000 revolving line of credit secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. The line of credit is formula-based which generally provides that the outstanding borrowings under the line of credit may not exceed an aggregate of 80% of eligible accounts receivable plus 10% of the value of eligible finished goods inventory. Interest is payable monthly. The interest rate is variable and is adjusted monthly based on the prime rate plus 1%. The prime rate at December 1, 2006 was 8.25%.

F-25

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
JUNE 30, 2006 AND 2005 (RESTATED)
(UNAUDITED)

The credit facility is subject to various financial covenants on a consolidated basis as follows. The minimum debt service coverage ratio must be greater than 1.20:1.00 on a trailing quarterly basis. "Debt service coverage ratio" is defined as net income after taxes, plus depreciation, plus amortization, plus or minus changes in deferred taxes, minus capital expenditures and minus any dividends or distributions, divided by the current maturities of long-term debt paid or scheduled to be paid plus any payments on subordinated debt. The credit facility also requires that the Company maintain a minimum book net worth, determined at the end of each calendar month, in an amount not less than \$26,900,000 for the months ended December 31, 2006, January 31, 2007 and February 28, 2007 and of not less than that amount plus 80% of the Company's net income for each calendar quarter ending on or after March 31, 2007 for each calendar month ending March 31, 2007, and each calendar month thereafter. The Company must not incur a net loss of greater than \$1,150,000 for 2006 and for each quarterly period occurring after December 31, 2006, the Company's net income must not be less than \$0. Management expects that the Company will not be in compliance with the bank's financial covenants as of

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December 31, 2006 and expects to obtain a waiver. If a waiver is not obtained and the loan is immediately payable, management believes that the Company has the resources to meet such a requirement.

In the event of a default and continuation of a default, Wells Fargo may accelerate the payment of the principal balance requiring the Company to pay the entire indebtedness outstanding on that date. From and after the maturity date of the credit facility, or any earlier date that all principal owing under the credit facility becomes due and payable by acceleration or otherwise, the outstanding principal balance will bear interest until paid in full at an increased rate per annum equal to 3% above the rate of interest in effect from time to time under the credit facility.

The credit facility also provides for a term loan of \$200,000 secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment, amortizable over 36 months at a variable rate equal to the prime rate plus 1%.

F-26

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

The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes to financial statements included elsewhere in this document. This report and our condensed consolidated financial statements and notes to financial statements contain forward-looking statements, which generally include the plans and objectives of management for future operations, including plans and objectives relating to our future economic performance and our current beliefs regarding revenues we might earn if we are successful in implementing our business strategies. The forward-looking statements and associated risks may include, relate to or be qualified by other important factors, including, without limitation:

- o the projected growth or contraction in the electronic components and communications equipment markets in which we operate;
- o our business strategy for expanding, maintaining or contracting our presence in these markets;
- o our ability to efficiently and effectively integrate and operate the businesses of our newly-acquired subsidiaries;
- o our ability to identify, fund and integrate additional businesses;
- o anticipated trends in our financial condition and results of operations; and
- o our ability to distinguish ourselves from our current and future competitors.

We do not undertake to update, revise or correct any forward-looking statements.

The information contained in this document is not a complete description of our business or the risks associated with an investment in our common stock. Before deciding to buy or maintain a position in our common stock, you should carefully review and consider the various disclosures we made in this report,

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and in our other materials filed with the Securities and Exchange Commission that discuss our business in greater detail and that disclose various risks, uncertainties and other factors that may affect our business, results of operations or financial condition. In particular, you should review our amended annual report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on December 15, 2006, and the "Risk Factors" we included in that report.

Any of the factors described above could cause our financial results, including our net income or loss or growth in net income or loss to differ materially from prior results, which in turn could, among other things, cause the price of our common stock to fluctuate substantially.

OVERVIEW

GENERAL

We are a leading supplier of timing and synchronization systems, rotary and digital switches, electronic power supplies and radio frequency, or RF, devices. We sell our products to communications service providers, defense and aerospace contractors and industrial customers. We are a multinational company operating out of facilities located in the United States, United Kingdom, France and Japan. As of December 31, 2006, we had approximately 300 employees.

2

We are a Delaware corporation that was formed July 14, 1989. We have three wholly-owned operating subsidiaries, EMRISE Electronics Corporation, a New Jersey corporation that was formed in 1983 ("EMRISE Electronics"), CXR Larus Corporation, a Delaware corporation that was formed in 1984 ("CXR Larus"), and CXR-Anderson Jacobson, a French company that was formed in 1973 ("CXR-AJ").

In December 2004, CXR Larus changed its name from CXR Telcom Corporation when it succeeded by merger to the assets and liabilities of Larus Corporation, a San Jose, California-based manufacturer and seller of telecommunications products, and Vista Labs, Incorporated, a subsidiary of Larus Corporation that provided engineering services to Larus Corporation. As described in more detail elsewhere in this report, we acquired Larus Corporation and Vista Labs, Incorporated in July 2004.

In March 2005, EMRISE Electronics Ltd. ("EEL"), a United Kingdom-based subsidiary of EMRISE Electronics, acquired Pascall Electronic (Holdings) Limited ("PEHL") and its wholly-owned subsidiary, Pascall Electronics Limited ("Pascall"). Pascall is based in the United Kingdom and manufactures a range of custom proprietary power systems and radio frequency ("RF") devices.

In September 2005, EMRISE Electronics acquired all of the outstanding common stock of RO Associates Incorporated ("RO"), a manufacturer of standard power supplies located in Sunnyvale, California.

Through our operating subsidiaries, CXR Larus, CXR-AJ and EMRISE Electronics, and through the divisions and subsidiaries of those subsidiaries, we design, develop, manufacture, assemble, and market products and services in the following two material business segments:

- o Electronic Components
 - digital and rotary switches

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- electronic power supplies
- RF and microwave devices
- o Communications Equipment
 - network access and transmission products
 - communication timing and synchronization products
 - communications test instruments

Sales to customers in the electronic components segment, primarily to aerospace customers, defense contractors and industrial customers, were approximately 73.2% and 50.6% of our total net sales during the six months ended June 30, 2006 and 2005, respectively. Sales of communications equipment and related services, primarily to private customer premises and public carrier customers, were approximately 26.8% and 49.4% of our total net sales during the six months ended June 30, 2006 and 2005, respectively.

Sales of our electronic components segment increased \$5,546,000 (54.2%) for the six months ended June 30, 2006 as compared to the six months ended June 30, 2005. Without the increase of sales of \$2,342,000 by our new subsidiary, RO, which we acquired on September 1, 2005, our electronic components segment sales would have increased by \$3,204,000 (14.9%) for the six months ended 2006 as compared to the same period in 2005, primarily due to increased sales of power supplies.

3

We experienced a \$1,480,000 (20.4%) decrease in sales in our communications equipment segment for the six months ended June 30, 2006. This decrease was primarily due to a low demand for our test equipment and timing systems by the major United States telecommunications companies, a delay in continued shipments on a long-term United States government infrastructure program due to customer technical issues, and delays in French military program orders for network access equipment.

LARUS CORPORATION ACQUISITION

In July 2004, we acquired Larus Corporation. Larus Corporation was a San Jose, California-based manufacturer and seller of telecommunications products that had one wholly-owned subsidiary, Vista Labs, Incorporated, or Vista, which provided engineering services to Larus Corporation. The basic purchase terms of the acquisition are described below. We consolidated the results of operations of Larus Corporation beginning from the date of acquisition, July 13, 2004. CXR Larus' United States-based sales and marketing staff, have secured relationships with two new major United States-based distributors, Power and Tel and Graybar, during 2005. We consolidated our CXR Larus subsidiary's operations into Larus Corporation's facility, which resulted in annual savings in rent and facilities expense of approximately \$250,000 beginning in the third quarter of 2004. Subsequent to March 31, 2005, we implemented further administrative, engineering and sales cost savings through staffing reductions of approximately \$700,000 on an annual basis as compared to our costs in the three months ended March 31, 2005. These staffing reductions related to eliminating redundancies in our electronic components segment personnel (including nine sales, marketing and administrative positions, one engineering director and the former CXR president) that occurred as a result of our acquisition of Larus Corporation.

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We paid \$6,539,500 to acquire the outstanding common stock of Larus Corporation. As a result, we acquired assets that included intellectual property, cash, accounts receivable and inventories owned by each of Larus Corporation and Vista. The purchase price for the acquisition consisted of \$1,000,000 in cash, the issuance of 1,213,592 shares of our common stock with a fair value of \$1,000,000, \$887,500 in the form of two short-term, zero interest promissory notes that were repaid in 2004, \$3,000,000 in the form of two subordinated secured promissory notes, warrants to purchase up to an aggregate of 150,000 shares of our common stock at \$1.30 per share and approximately \$580,000 of acquisition costs. The number of shares of our common stock issued as part of the purchase price was calculated based on the \$0.824 per share average closing price of our common stock for the five trading days preceding the transaction. The warrants to purchase 150,000 shares of common stock were valued at \$72,000 using a Black-Scholes formula that included a volatility of 107.19%, an interest rate of 3.25%, a life of three years and no assumed dividend.

In addition, we assumed \$245,000 in accounts payable and accrued expenses and entered into an above-market real property lease with the sellers. This lease represents an obligation that exceeds the fair market value by approximately \$756,000 and is part of the acquisition accounting. The cash portion of the acquisition purchase price was funded with proceeds from our credit facility with Wells Fargo Bank, N.A. and cash on-hand.

In conjunction with our acquisition of Larus Corporation, we commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The study is complete and the intangible values are as follows: Larus trade name and trademark are valued at \$750,000 compared to our initial estimate of \$2,800,000, and the technology and customer relationships are valued at \$1,350,000 as compared to our initial estimate of \$800,000. Goodwill associated with the Larus Corporation acquisition totaled \$4,043,000. The Larus trade name and trademark were determined to have indefinite lives and therefore are not being amortized but rather are being periodically tested for impairment. The technology and customer relationships were both estimated to have ten-year lives and, as a result, \$162,000 of amortization expense was recorded and charged to administrative expense in 2005.

4

PASCALL ACQUISITION

On March 18, 2005, our subsidiary, EEL, purchased all of the outstanding capital stock of PEHL, the parent holding company of Pascall, using funds loaned to EEL by EMRISE. The purchase price for the acquisition totaled \$9,669,000, subject to adjustments as described below, and included a \$5,972,000 cash payment to PEHL's former parent, a \$3,082,000 loan to PEHL and Pascall and approximately \$615,000 in acquisition costs.

The initial portion of the purchase price was 3,100,000 British pounds sterling (approximately U.S. \$5,972,000 based on the exchange rate in effect on March 18, 2005). The initial portion of the purchase price was paid in cash and was subject to adjustment on a pound for pound basis to the extent that the value of the net assets of Pascall as of the closing date was greater or less than 2,520,000 British pounds sterling. On May 6, 2005, we submitted to Intelek Properties Limited (which is a subsidiary of Intelek PLC, a London Stock Exchange public limited company, and is the former parent of PEHL), our calculation of the value of the net assets of Pascall as of the closing date, which we believed slightly exceeded 2,520,000 British pounds sterling. Ultimately, the parties determined that the value of the net assets of Pascall

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at the closing date was 2,650,000 British pounds sterling. As a result, we paid to Intelek Properties Limited 130,000 British pounds sterling (approximately U.S. \$236,000 based on the exchange rate then in effect) on August 1, 2005 to satisfy this obligation. The purchase price is also subject to downward adjustments for any payments that may be made to EEL under indemnity, tax or warranty provisions of the purchase agreement.

EEL loaned to Pascall and PEHL at the closing 1,600,000 British pounds sterling (approximately U.S. \$3,082,000 based on the exchange rate in effect on March 18, 2005). The loaned funds were used to immediately repay outstanding intercompany debt owed by Pascall and PEHL to Intelek Properties Limited.

In conjunction with the acquisition of Pascall, we commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. We considered whether the acquisition included various types of identifiable intangible assets, including trade names, trademarks, patents, covenants not to compete, customers, workforce, technology and software. We have recorded the value of the trade name and trademark at \$500,000, covenants not to compete that were obtained from Pascall's former affiliates at \$200,000, amortizable over three years and backlog at \$200,000 amortizable over two years. We believe that no other identifiable intangible assets of value were acquired. No patents were acquired. We have not ascribed any value to Pascall's customer base because our United Kingdom subsidiary, XPS, already was selling to Pascall's key customers. Pascall's workforce does not hold any special skills that are not readily available from other sources. We did not identify any valuable completed technology that was acquired, because Pascall utilizes non-proprietary technology to produce custom power supplies pursuant to customer specifications. Pascall does not develop or design software and does not own software of any material value.

In accordance with the valuation study and taking into consideration post-closing adjustments, we have recorded goodwill associated with the Pascall acquisition of \$4,634,000 compared to the initial goodwill recorded of \$4,571,000.

5

RO ASSOCIATES ACQUISITION

On September 2, 2005, our EMRISE Electronics subsidiary acquired all of the issued and outstanding shares of common stock of RO, a California corporation, under the terms of a stock purchase agreement dated effective as of August 31, 2005 and amended as of September 28, 2005. Prior to the acquisition, all of the common stock of RO was owned by Robert H. Okada as Trustee of the Robert H. Okada Trust Agreement dated February 11, 1992, and Sharon Vavro, an individual.

The purchase price consisted of \$2,400,000 in cash paid at closing and an additional \$600,000 in cash payable in two equal installments on October 6, 2005 and March 31, 2006. The acquisition purchase price was funded with cash on-hand. The purchase price is subject to adjustment based on the value of the stockholders' equity, accounts receivable, accounts payable, cash on hand and net inventory of RO, as determined by the consolidated, unaudited balance sheet as of August 31, 2005, prepared in accordance with accounting principles generally accepted in the United States of America. In addition, concurrently with the closing of the acquisition of RO, EMRISE Electronics paid in full all then existing credit facilities of RO in the aggregate amount of \$1,602,000.

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In determining the purchase price for RO, EMRISE Electronics considered the historical and expected earnings and cash flow of RO, as well as the value of companies of a size and in an industry similar to RO, comparable transactions and the market for such companies generally. The purchase price represented a premium of approximately \$2,275,000 over the \$2,340,000 recorded net worth of the assets of RO. In determining this premium, EMRISE Electronics considered the synergistic and strategic advantages provided by having a United States-based power conversion manufacturer and the value of the goodwill, customer relationships and technology of RO. Goodwill associated with the RO acquisition totaled approximately \$1,376,000. EMRISE commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The valuation study of RO's intangibles was completed in June 2006. We initially estimated the intangibles to be valued as follows: technology, \$484,000, trademarks, \$300,000 and customer relationships, \$200,000. The valuation study resulted in the following valuations: technology, \$500,000, trademarks, \$350,000 and customer relationships, \$350,000. The intangibles were adjusted to the appraised values in the second quarter of 2006. The technology and customer relationships are being amortized over 10 years on their appraise values and the trademarks are not being amortized due to the inability to determine an estimated life.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of those financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of net sales and expenses for each period. The following represents a summary of our critical accounting policies, defined as those policies that we believe are the most important to the portrayal of our financial condition and results of operations and that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

REVENUE RECOGNITION

We derive revenues from sales of electronic components and communications equipment products and services. Our sales are based upon written agreements or purchase orders that identify the type and quantity of the item being purchased and the purchase price. We recognize revenues when shipment of products has occurred or services have been rendered, no significant obligations remain on our part, and collectibility is reasonably assured based on our credit and collections practices and policies.

We recognize revenues from domestic sales of our electronic components and communications equipment at the point of shipment of those products. Product returns are infrequent and require prior authorization because our sales are final and we quality test our products prior to shipment to ensure they meet the specifications of the binding purchase orders under which they are shipped. Normally, when a distributor requests and receives authorization to return a product, the request is accompanied by a purchase order for a replacement product. When an end-user requests to return a product, we either repair or replace the product.

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Revenue recognition for products and services provided by our United Kingdom subsidiaries depends upon the type of contract involved. Engineering/design services contracts generally entail design and production of a prototype over a term of up to several years, with all revenue deferred until all services under the contracts have been completed. Production contracts provide for a specific quantity of products to be produced over a specific period of time. Customers issue binding purchase orders for each suborder to be produced. At the time each suborder is shipped to the customer, we recognize revenue relating to the products included in that suborder. Returns are infrequent and permitted only with prior authorization because these products are custom made to order based on binding purchase orders and are quality tested prior to shipment. Generally, these products carry a one-year limited parts and labor warranty. We do not offer customer discounts, rebates or price protection on these products.

We recognize revenues for products sold by our French subsidiary at the point of shipment. Customer discounts are included in the product price list provided to the customer. Returns are infrequent and permitted only with prior authorization because these products are shipped based on binding purchase orders and are quality tested prior to shipment. Generally, these products carry a two-year limited parts and labor warranty.

Generally, our electronic components, network access and transmission products and satellite communication timing and synchronization products carry a one-year limited parts and labor warranty and our communications test instruments and European network access and transmission products carry a two-year limited parts and labor warranty. Products returned under warranty are tested and repaired or replaced at our option. Historically, warranty repairs have not been material. We do not offer customer discounts, rebates or price protection on these products.

Revenues from services such as repairs and modifications are recognized when the service has been completed and invoiced. For repairs that involve shipment of a repaired product, we recognize repair revenues when the product is shipped back to the customer. Service revenues represented approximately 3.6% and 4.0% of net sales for the three and six month periods ending June 30, 2006, respectively.

INVENTORY VALUATION

Our finished goods electronic components inventories generally are built to order. Our communications equipment inventories generally are built to forecast, which requires us to produce a larger amount of finished goods in our communications equipment business so that our customers can promptly be served. Our products consist of numerous electronic and other parts, which necessitates that we exercise detailed inventory management. We value our inventory at the lower of the actual cost to purchase or manufacture the inventory (first-in, first-out) or the current estimated market value of the inventory (net realizable value). We perform physical inventories at least once a year. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and production requirements for the next twelve months. Additionally, to determine inventory write-down provisions, we review product line inventory levels and individual items as necessary and periodically review assumptions about forecasted demand and market conditions. Any parts or finished goods that we determine are obsolete, either in connection with the physical count or at other times of observation, are reserved for and subsequently discarded and written-off.

In addition, the communications equipment industry is characterized by rapid technological change, frequent new product development, and rapid product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. Also, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. Although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results.

FOREIGN CURRENCY TRANSLATION

We have foreign subsidiaries that together accounted for approximately 62.0% of our net revenues, 51.2% of our assets and 53.9% of our total liabilities as of and for the six months ended June 30, 2006. In preparing our consolidated financial statements, we are required to translate the financial statements of our foreign subsidiaries from the currencies in which they keep their accounting records into United States dollars. This process results in exchange gains and losses which, under relevant accounting guidance, are included either within our statement of operations or as a separate part of our net equity under the caption "accumulated other comprehensive income (loss)."

Under relevant accounting guidance, the treatment of these translation gains or losses depends upon our management's determination of the functional currency of each subsidiary. This determination involves consideration of relevant economic facts and circumstances affecting the subsidiary. Generally, the currency in which the subsidiary transacts a majority of its transactions, including billings, financing, payroll and other expenditures, would be considered the functional currency. However, management must also consider any dependency of the subsidiary upon the parent and the nature of the subsidiary's operations.

If management deems any subsidiary's functional currency to be its local currency, then any gain or loss associated with the translation of that subsidiary's financial statements is included as a separate component of stockholders' equity in accumulated other comprehensive income (loss). However, if management deems the functional currency to be United States dollars, then any gain or loss associated with the translation of these financial statements would be included within our statement of operations.

If we dispose of any of our subsidiaries, any cumulative translation gains or losses would be realized into our statement of operations. If we determine that there has been a change in the functional currency of a subsidiary to United States dollars, then any translation gains or losses arising after the date of the change would be included within our statement of operations.

Based on our assessment of the factors discussed above, we consider the functional currency of each of our international subsidiaries as each subsidiary's local currency. Accordingly, we had cumulative translation losses of \$187,000 and \$870,000 that were included as part of accumulated other comprehensive income within our balance sheets at June 30, 2006 and December 31, 2005, respectively. During the six months ended June 30, 2006 and 2005, we included translation adjustments of a gain of approximately \$683,000 and a loss of \$756,000, respectively, under accumulated other comprehensive income (loss).

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If we had determined that the functional currency of our subsidiaries was United States dollars, these gains or losses would have decreased or increased our gain or loss for the three months ended 2006 and 2005. The magnitude of these gains or losses depends upon movements in the exchange rates of the foreign currencies in which we transact business as compared to the value of the United States dollar. These currencies include the euro, the British pound sterling and the Japanese yen. Any future translation gains or losses could be significantly higher or lower than those we recorded for these periods.

A \$6,312,000 loan payable from EEL to EMRISE was outstanding as of June 30, 2006. This loan is expected to be outstanding indefinitely. Therefore, exchange rate losses and gains on this loan are recorded in cumulative translation gains or losses in the equity section of the balance sheet.

INTANGIBLES, INCLUDING GOODWILL

We periodically evaluate our intangibles, including goodwill, for potential impairment. Our judgments regarding the existence of impairment are based on legal factors, market conditions and operational performance of our acquired businesses.

In assessing potential impairment of goodwill, we consider these factors as well as forecasted financial performance of the acquired businesses. If forecasts are not met, we may have to record additional impairment charges not previously recognized. In assessing the recoverability of our goodwill and other intangibles, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of those respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets that were not previously recorded. If that were the case, we would have to record an expense in order to reduce the carrying value of our goodwill. On January 1, 2002, we adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," and were required to analyze our goodwill for impairment issues by June 30, 2002, and then at least annually after that date or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. At December 31, 2005, the reported goodwill totaled \$12,066,000. During 2005, we did not record any impairment losses related to goodwill and other intangible assets.

RESULTS OF OPERATIONS

The table presented below, which compares our results of operations for the three months ended June 30, 2006 to our results of operations for the three months ended June 30, 2005, presents the results for each period, the change in those results from one period to another in both dollars and percentage change, and the results for each period as a percentage of net sales. The columns present the following:

- o The first two data columns show the absolute results for each period presented.
- o The columns entitled "Dollar Variance" and "Percentage Variance" show the change in results, both in dollars and percentages. These two columns show favorable changes as a positive and unfavorable changes as negative. For example, when our net sales increase from one period to the next, that change is shown as a positive number in both columns. Conversely, when expenses increase from one period to the next, that change is shown as a negative in both columns.
- o The last two columns show the results for each period as a percentage of net sales.

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9

THREE MONTHS ENDED JUNE 30, 2006 COMPARED TO THREE MONTHS ENDED JUNE 30, 2005

| | THREE MONTHS ENDED JUNE 30, | | DOLLAR VARIANCE | PERCENTAGES VARIANCE |
|--|--------------------------------|--------------------|----------------------------|----------------------------|
| | 2006 | 2005 (RESTATED) | FAVORABLE (UNFAVORABLE) | FAVORABLE (UNFAVORABLE) |
| | (IN THOUSANDS) | | | |
| Net sales | | | | |
| Electronic components | \$ 7,920 | \$ 6,421 | \$ 1,499 | 23.3% |
| Communications equipment | 2,897 | 3,541 | (644) | (18.2%) |
| Total net sales | 10,817 | 9,962 | 855 | 8.6% |
| Cost of sales | | | | |
| Electronic components | 5,207 | 4,084 | (1,123) | (27.5%) |
| Communications equipment | 1,818 | 1,915 | 97 | 5.1% |
| Total cost of sales | 7,025 | 5,999 | (1,026) | (17.1%) |
| Gross profit | | | | |
| Electronic components | 2,713 | 2,337 | 376 | 16.1% |
| Communications equipment | 1,079 | 1,626 | (547) | (33.6%) |
| Total gross profit | 3,792 | 3,963 | (171) | (4.3%) |
| Selling, general and administrative expenses | 3,698 | 3,447 | (251) | 7.3% |
| Engineering and product development | 892 | 604 | (288) | (47.7%) |
| Operating loss | (798) | (88) | (710) | (806.8%) |
| Interest expense | (93) | (94) | 1 | 1.1% |
| Interest income | 21 | 37 | (16) | (43.2%) |
| Other income and expense | (44) | 115 | (159) | (138.3%) |
| Loss before income tax expense | (914) | (30) | (884) | (2,946.7%) |
| Income tax expense (benefit) | 96 | (51) | (147) | (288.2%) |
| Net income (loss) | \$ (1,010) | \$ 21 | \$ (1,031) | (4,909.5%) |

NET SALES. The \$855,000 increase in total net sales resulted from the combination of a \$1,499,000 increase in net sales of our electronic components and a \$644,000 decrease in net sales of our communications equipment products and services.

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ELECTRONIC COMPONENTS. The increase in net sales of our electronic components segment resulted primarily from \$1,103,000 of power supply sales from RO, which we acquired on September 1, 2005, and an increase in sales of power supplies of \$274,000 at XPS, due to some key contracts being pulled forward. We also experienced a decrease in sales of switches from Emrise Electronics' Digitran Division of \$163,000, or 8.7%, to \$1,712,000 from \$1,875,000 in the prior year period, due to lower volume. Excluding the increased sales contributed by RO, our net sales for this segment would have been \$6,817,000 which represents a \$396,000 (6.2%) increase over net sales of \$6,421,000 for the three months ended June 30, 2005. This increase was caused by the increase in sales of power supplies of \$673,000 partially offset by a small decrease in switch sales.

COMMUNICATIONS EQUIPMENT. The decrease in sales of our communication equipment segment was largely due to a \$354,000 (60.9%) decrease in net sales of test equipment to \$227,000 as compared to \$581,000 in the prior period attributable to a delay in expected orders from a government refurbishment

10

project. We also incurred a \$368,000 (47.8%) decrease in sales of synchronous timing systems to \$402,000 from \$770,000 in the prior year due to stronger competitive products. CXR-AJ experienced a \$28,000 reduction in net sales of network access products. Sales of U.S.-based network access system products by CXR Larus improved by \$80,000 to \$694,000 as compared to \$614,000 in the prior year period. We anticipated that sales of our communications test equipment will be less in 2006 than in 2005. However, we anticipate that sales of our network access products, both in France and more importantly in the United States, will grow as new sales channels and our stronger marketing presence becomes effective and we work to utilize our two new United States-based distributors we established relationships with during the first quarter of 2006.

GROSS PROFIT. The decrease in gross profit as a percentage of total net sales and the dollar decrease in total gross profit resulted from an increase in gross profit in our electronic components segment that was offset by a decrease in gross profit in our communications equipment segment.

ELECTRONIC COMPONENTS. The increase in gross profit for our electronic components segment was primarily due to contributions from RO, which amounted to \$263,000 of the increase. In addition, gross profit from our other power supply operations in the U.K. increased \$199,000 (15.0%) to \$1,525,000 as compared to \$1,326,000 in the prior year period due to increased sales volume. Gross profit from Digitran decreased slightly by \$98,000 to \$740,000 from \$838,000 in the prior year due to product mix.

COMMUNICATIONS EQUIPMENT. The decrease in gross profit for our communications equipment segment was primarily due to \$239,000 (82.1%) decrease in gross profit from test instruments produced by CXR Larus to \$52,000 from \$291,000 in the prior year due to lower sales. We also experienced a reduction of \$209,000 (30.5%) in gross profit of CXR-AJ network access products to \$477,000 from \$686,000 in the prior year period due to product mix. Also, the gross margins of CXR Larus synchronous timing devices and network access products decreased \$239,000 (30.3%) to \$549,000 from \$788,000 in the prior period due to lower per-unit overhead absorption due to lower volume.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The increase in selling, general and administrative expenses was primarily due to:

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- o an \$87,000 (6.8%) decrease in other selling and marketing expenses primarily due to the decrease of \$159,000 (39.0%) of selling expenses, excluding commissions at CXR Larus to \$249,000 as compared to \$408,000 in the prior year period due to reorganizing the marketing and selling functions, offset by a \$72,000 increase in such expenses in our electronic components segment, primarily due to inclusion of RO's marketing and selling expenses of \$129,000, offset with a \$45,000 reduction in such expense of U.K. produced power supplies;
- o a \$348,000 (17.8%) increase in administrative expenses, primarily due to the inclusion of \$132,000 of administrative costs for RO and a \$162,000 increase in corporate legal and auditing expenses; and
- o \$133,000 of expenses related to our investigation of an accounting matter resulting in the subsequent reaudit of 2003, 2004 and 2005 and the restatement of 2004 and 2005 financial statements.

We anticipate that selling, general and administrative expenses for the remainder of 2006 will remain at levels higher than those we experienced during 2005 due to the RO acquisitions, increased investments in new products, sales and marketing expenses for our new low profile rotary and digital switches, increased activity in searching for and analyzing potential acquisitions, expansion of our investor relations program and increased corporate governance activities in response to the Sarbanes-Oxley Act of 2002 and recently adopted rules and regulations of the Securities and Exchange Commission.

11

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of engineering and product development activities. The increase in these expenses resulted primarily from a \$338,000 (228.4%) increase in the development of an improved satellite synchronous timing device and the inclusion of \$84,000 engineering costs at RO. These increases were partially offset with a reduction in engineering expenses of test equipment, switches and power supplies of \$36,000, \$41,000 and \$40,000, respectively. We expect this higher level of expense to continue throughout 2006 as we continue to develop our new satellite synchronous timing device, our new family of rotary switches and pursue long-term opportunities in the timing and synchronization market.

INTEREST EXPENSE, NET. Interest expense stayed constant at \$93,000. Our interest income declined due to the use of cash for the acquisition of Pascall on March 18, 2005 and the acquisition of RO on September 1, 2005.

INCOME TAX EXPENSE. We recorded \$70,000 of foreign income tax and \$26,000 of state income and franchise tax. We did not record any U.S. federal income tax as we incurred a taxable loss from U.S. sources and have net operating loss carryover available.

NET INCOME. A significant contributing factor to our net loss was our investment in heavy product development at CXR Larus, a decline in timing system and test instrument sales, and lower gross margins experienced by CXR-AJ.

12

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SIX MONTHS ENDED JUNE 30, 2006 COMPARED TO SIX MONTHS ENDED JUNE 30, 2005 (RESTATED)

| | SIX MONTHS ENDED JUNE 30, | | DOLLAR VARIANCE | PERCENTAGES VARIANCE |
|--|------------------------------|--------------------|----------------------------|----------------------------|
| | 2006 | 2005 (RESTATED) | FAVORABLE (UNFAVORABLE) | FAVORABLE (UNFAVORABLE) |
| | (IN THOUSANDS) | | | |
| Net sales | | | | |
| Electronic components | \$ 15,773 | \$ 10,227 | \$ 5,546 | 54.2% |
| Communications equipment | 5,778 | 7,258 | (1,480) | (20.4%) |
| Total net sales | 21,551 | 17,485 | 4,066 | 23.3% |
| Cost of sales | | | | |
| Electronic components | 9,994 | 6,451 | (3,543) | (54.9%) |
| Communications equipment | 3,381 | 3,793 | 412 | 10.9% |
| Total cost of sales | 13,375 | 10,244 | (3,131) | (30.6%) |
| Gross profit | | | | |
| Electronic components | 5,779 | 3,776 | 2,003 | 53.0% |
| Communications equipment | 2,397 | 3,465 | (1,068) | (30.8%) |
| Total gross profit | 8,176 | 7,241 | 935 | 12.9% |
| Selling, general and administrative expenses | 7,465 | 6,291 | (1,174) | (18.7%) |
| Engineering and product development | 1,614 | 1,136 | (478) | (42.1%) |
| Operating loss | (903) | (186) | (717) | (385.5%) |
| Interest expense | (217) | (196) | (21) | 10.7% |
| Interest income | 46 | 109 | (63) | (57.8%) |
| Other income and expense | (36) | 112 | (148) | (132.1%) |
| Loss before income tax expense | (1,110) | (161) | (949) | (589.4%) |
| Income tax expense | 222 | 15 | (207) | (1,380.0%) |
| Net loss | \$ (1,332) | \$ (176) | \$ (1,156) | (656.8%) |

NET SALES. The \$4,066,000 increase in total net sales resulted from the combination of a \$5,546,000 increase in net sales of our electronic components and a \$1,480,000 decrease in net sales of our communications equipment products and services.

ELECTRONIC COMPONENTS. The increase in net sales of our electronic components segment was attributable to, among other things, \$6,825,000 in sales of Pascall power supplies and RF components and \$2,342,000 in sales of RO power supplies. Because Pascall was acquired on March 18, 2005, sales attributable to Pascall during the first quarter of 2005 were negligible. We acquired RO on September 1, 2005 and, as a result, we did not report any RO sales in the first quarter of 2005. We also experienced an increase in sales of switches produced

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by Emrise Electronics' Digitran Division of \$174,000, or 5.2%, to \$3,522,000 from \$3,348,000 in the prior year period due to increased volume. Excluding the increased sales contributed by Pascall and RO, our net sales for this segment would have been \$11,368,000 which represents a \$1,141,000 (11.2%) increase over net sales of \$10,227,000 for the six months ended June 30, 2005. This increase was caused by an increase in switch and power supply sales by XPS.

COMMUNICATIONS EQUIPMENT. The decrease in sales of our communication equipment segment was primarily due to an \$888,000 (68.1%) decrease in net sales of test equipment to \$416,000 as compared to \$1,304,000 in the prior period due to a delay in expected orders from a government refurbishment project. We also

13

incurred a \$250,000 (6.1%) decrease in sales of network access equipment to \$3,879,000 from \$4,129,000 in the prior year period. This decrease consisted of a \$137,000 decrease in net sales of network access products by CXR Larus due to lower volume. CXR-AJ experienced a \$113,000 reduction in net sales of network access products. We also experienced a decrease in sales of synchronous timing products of \$340,000 (30.4%) to \$780,000 as compared to \$1,120,000 in the prior year period due to lower volume.

GROSS PROFIT. The decrease in gross profit as a percentage of total net sales and the dollar increase in total gross profit resulted from an increase in gross profit of \$2,003,000 in our electronic components segment that was partially offset by a decrease in gross profit of \$1,068,000 in our communications equipment segment.

ELECTRONIC COMPONENTS. The increase in gross profit for our electronic components segment was primarily due to contributions from Pascall and RO, which amounted to \$1,181,000 and \$653,000, respectively, of the increase. In addition, gross profit from Digitran, which produces digital and rotary switches, increased \$233,000 (15.7%) to \$1,713,000 as compared to \$1,480,000 in the prior year period due to favorable product mix. Gross profit from XPS's power supply and RF operations decreased slightly by \$43,000 to \$892,000 from \$935,000 in the prior year period due to product mix.

COMMUNICATIONS EQUIPMENT. The decrease in gross profit for our communications equipment segment was primarily due to a \$720,000 (85.7%) decrease in gross profit from test instruments produced by CXR Larus to \$120,000 from \$840,000 in the prior year period due to lower sales. We also experienced a reduction of \$370,000 (28.5%) in gross profit of CXR-AJ network access products to \$930,000 from \$1,300,000 in the prior year period due to product mix. Our gross profit of CXR Larus synchronous timing devices and network access products increased by \$22,000 (1.7%) to \$1,347,000 as compared to \$1,621,000 in the prior year period despite a \$319,000 reduction in sales due to higher gross margins.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The increase in selling, general and administrative expenses was primarily due to:

- o a \$44,000 (11.5%) increase in sales commissions to \$127,000, primarily due to the inclusion of Pascall and RO sales commissions, partially offset by a reduction of \$73,000 of sales commissions due to lower test instrument sales;
- o a \$211,000 (17.5%) increase in other selling and marketing expenses, primarily due to the increase and inclusion of Pascall and RO selling expenses of \$253,000 and \$203,000, respectively, offset by a \$199,000 reduction in such expenses in our communication equipment segment,

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especially at CXR Larus due to staff reductions from a reorganization of the sales and market functions;

- o an \$801,000 (22.4%) increase in administrative expenses primarily due to the inclusion of \$357,000 and \$259,000 of administrative costs for Pascall and RO, respectively, an increase of \$154,000 in corporate legal and auditing expenses and \$58,000 in stock option expenses. These increases were partially offset by a \$256,000 reduction in administrative expenses in our communication equipment segment due to layoffs and consolidation of our test equipment business;
- o an approximate \$200,000 increase due to the revised estimate of a liability for a deferred compensation arrangement and other miscellaneous matters; and

14

- o \$133,000 for the investigation leading to the subsequent reaudit of 2003, 2004 and 2005 financial statements and the reissuance of 2004 and 2005 financial statements.

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of engineering and product development activities. The increase in these expenses resulted primarily from the increase and inclusion of \$97,000 and \$187,000 in expenses attributable to Pascall and RO, respectively. Also, engineering expenses increased by \$329,000 (97.6%) at CXR Larus for the development of a new synchronous timing device. The increases were partially offset by a reduction in engineering expenses of \$54,000 to \$227,000 from \$281,000 in the prior year period for rotary switch development.

INTEREST EXPENSE, NET. Interest expense increased due to increased loan balances at our U.K. operations. Our interest income declined due to the use of cash for the acquisitions of Pascall and RO.

INCOME TAX EXPENSE. Income tax expense of \$222,000 consisted of \$151,000 of foreign income tax applicable to our foreign source earnings and \$71,000 state income and franchise taxes. No U.S. federal taxes were recorded as we had no U.S. source taxable income and have net operating loss carryover available.

NET INCOME. The increase in net loss was a result of lower sales of test instruments and synchronous timing devices at CXR Larus combined with the costs associated with CXR Larus' engineering program to develop a new and substantially improved timing device by the end of the third quarter. Also contributing to the loss were lower gross margins at CXR-AJ and increased corporate legal and accounting costs. These negatives were partially offset with robust business at our power supply and RF business units in the U.K. and an improved operating profit for switches as well as power supplies and RF components.

LIQUIDITY AND CAPITAL RESOURCES

During the six months ended June 30, 2006, we funded our operations primarily through revenue generated from our operations and through our existing and previous lines of credit with Wells Fargo Bank, N.A. and various foreign banks. During the six months ended June 30, 2006, we continued to rely on our foreign credit facilities. In addition, we raised approximately \$16,060,000 in net proceeds through a private placement of equity securities in January 2005 as described below to support our acquisition program. As of June 30, 2006, we had working capital of \$12,651,000, as compared to \$12,958,000 at December 31, 2005.

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At June 30, 2006 and December 31, 2005, we had accumulated deficits of \$16,450,000 and \$15,118,000, respectively, and cash and cash equivalents of \$2,204,000 and \$4,371,000, respectively.

Accounts receivable decreased \$2,206,000 (23.4%) during the first six months of 2006 from \$9,413,000 as of December 31, 2005 to \$7,207,000 as of June 30, 2005 due to lower sales. Days sales outstanding, which is a measure of our average accounts receivable collection period, decreased from 61 days for 2005 to 68 days for the first six months of 2006. Our customers include many Fortune 100 companies in the United States and similarly large companies in Europe and Asia. Because of the financial strength of our customer base, we incur few bad debts.

Inventory balances increased \$1,259,000 (12.3%) during the first six months of 2006, from \$10,277,000 at December 31, 2005 to \$11,547,000 at June 30, 2006. Inventory represented 27.4% and 23.1% of our total assets as of June 30, 2006 and December 31, 2005, respectively. Inventory turnover, which is a ratio that indicates how many times our inventory is sold and replaced over a specified period, decreased to 2.5 times for the first six months of 2006 as compared to 2.8 times for the same period in 2005.

15

We took various actions to reduce costs in 2005 and 2004. These actions were intended to reduce the cash outlays of our communications equipment segment to match its revenue rate, which was negatively impacted by the telecommunications downturn of 2002 and 2003. We also have contracted with offshore manufacturers for production of test equipment at lower prices than our previous cost for in-house manufacturing. We have also contracted with Hitachi to outsource the manufacture of our satellite communication timing devices beginning approximately in the second quarter of 2006. We merged Larus Corporation with and into CXR Telcom Corporation at the end of 2004 and integrated their operations.

Cash used in our operating activities totaled \$660,000 for the first six months of 2006 as compared to cash used in operating activities of \$325,000 for the prior year period. This \$335,000 decrease in operating cash flows primarily resulted from an increase in inventories.

Cash used in our investing activities totaled \$156,000 for the first six months of 2006 as compared to \$9,776,000 for the first six months of 2005. Included in the results for 2005 are net cash of \$9,627,000 used to acquire Pascall, including acquisition costs.

Cash used in our financing activities totaled \$1,733,000 for the first six months of 2006 as compared to \$16,211,000 of cash provided by our financing activities for the first six months of 2005. The change is primarily due to the net proceeds from the issuance of common stock in the January 2005 private placement.

Outstanding borrowings under our revolving lines of credit were as follows:

| | June 30, 2006 | December 31, 2005 |
|--|------------------|----------------------|
| Line of credit with a U.S. commercial lender | \$ -- | \$ -- |
| Lines of credit with foreign banks | 1,550,000 | 3,283,000 |

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| | |
|--------------|--------------|
| \$ 1,550,000 | \$ 3,283,000 |
| ===== | ===== |

On August 25, 2005, we and two of our subsidiaries, CXR Laurus and EMRISE Electronics, acting as guarantors, obtained a \$9,000,000 revolving line of credit facility from Wells Fargo Bank, N.A. for the our domestic operations. As guarantors, each of CXR Larus and EMRISE Electronics was jointly and severally liable with EMRISE for up to \$9,000,000. This facility was initially effective through September 1, 2006. The credit facility had no prepayment penalty and was subject to an unused commitment fee equal to 0.25% per annum, payable quarterly based on the average daily unused amount of the line of credit.

As of June 30, 2006, we had no outstanding balance owing under the revolving credit line, and we had \$3,000,000 of availability on the non-formula based portion of the credit line. As of June 30, 2006, we were in compliance with each of the covenants of the credit facility. The credit facility also provides for a term loan of \$150,000 secured by equipment, amortizable over 36 months at a variable rate equal to the prime rate plus 1.5%. The term loan portion of the facility had a balance of \$50,000 at June 30, 2006.

As of June 30, 2006, we had approximately \$142,000 of capital leases outstanding, which amount is included in long term debt in the accompanying condensed consolidated financial statements.

16

On September 19, 2006, we entered into a Third Amendment to Credit Agreement effective as of September 1, 2006 with Wells Fargo Bank. The amendment provided for the waiver by Wells Fargo Bank of certain violations of financial covenants in our existing credit facility. The amendment also provided for the reduction in the amount of the credit facility from \$9.0 million to \$1.5 million and limited borrowings to 80% of eligible accounts receivable. In connection with the amendment, we executed a Revolving Line of Credit Note dated September 1, 2006 in the amount of \$1.5 million. On October 9, 2006, we executed a letter agreement dated effective October 1, 2006 with Wells Fargo Bank extending the maturity date of the \$1.5 million note to October 20, 2006.

On November 13, 2006, Wells Fargo Bank issued a notice of default and demand for payoff with respect to the \$1.5 million note. All obligations under the note were due and payable on November 20, 2006. On November 24, 2006, we entered into a Forbearance Agreement with Wells Fargo Bank, dated effective as of November 20, 2006, whereby Wells Fargo Bank agreed to forbear from exercising its rights under the credit facility as described in the notice of default and demand for payoff through December 1, 2006. On December 1, 2006, EMRISE Corporation, EMRISE Electronics, CXR Larus, RO and Wells Fargo Bank acting through its Wells Fargo Business Credit operating division ("WFBC") entered into a Credit and Security Agreement providing for a revolving line of credit and term loan. On December 5, 2006, we paid off the \$1.5 million Wells Fargo Bank credit facility in full.

The credit facility with WFBC provides for a \$5.0 million revolving line of credit that expires on December 1, 2009. If WFBC terminates the credit facility during a default period, or if we terminate or reduce the credit facility prior to the maturity date, or if we prepay the term loan portion of the facility, we will be subject to penalties as follows: if the termination or prepayment occurs during the one year period after the initial funding date, the penalty is equal to 3% of the maximum line amount and/or prepayment amount; if the termination or prepayment occurs during second year after the initial funding date, the penalty is equal to 2% of the maximum line amount and/or

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prepayment amount; and if the termination or prepayment occurs at any time after the second anniversary of the initial funding date and prior to the maturity date, the penalty is equal to 1% of the maximum line amount and/or prepayment amount. The credit facility is subject to an unused line fee equal to 0.25% per annum, payable monthly based on the average daily unused amount of the line of credit described in the following paragraph. The credit facility is also subject to a minimum monthly interest charge of \$8,500 with respect to the revolving line of credit.

The WFBC credit facility provides a \$5,000,000 revolving line of credit secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. The line of credit is formula-based which generally provides that the outstanding borrowings under the line of credit may not exceed an aggregate of 80% of eligible accounts receivable plus 10% of the value of eligible finished goods inventory. Interest is payable monthly. The interest rate is variable and is adjusted monthly based on the prime rate plus 1%. The prime rate at December 1, 2006 was 8.25%.

The credit facility is subject to various financial covenants on a consolidated basis as follows. The minimum debt service coverage ratio must be greater than 1.20:1.00 on a trailing quarterly basis. "Debt service coverage ratio" is defined as net income after taxes, plus depreciation, plus amortization, plus or minus changes in deferred taxes, minus capital expenditures and minus any dividends or distributions, divided by the current maturities of long-term debt paid or scheduled to be paid plus any payments on subordinated debt. The credit facility also requires that we maintain a minimum book net worth, determined at the end of each calendar month, in an amount not less than \$26,900,000 for the months ended December 31, 2006, January 31, 2007 and February 28, 2007 and of not less than that amount plus 80% of our net income for each calendar quarter ending on or after March 31, 2007 for each calendar month ending March 31, 2007, and each calendar month thereafter. We

17

must not incur a net loss of greater than \$1,150,000 for 2006 and for each quarterly period occurring after December 31, 2006, our net income must not be less than \$0. We expect we will not be in compliance with the bank's financial covenants as of December 31, 2006 and we expect to obtain a waiver. If we do not obtain a waiver and the loan is immediately payable, we believe that we will have the resources to meet such a requirement.

In the event of a default and continuation of a default, Wells Fargo may accelerate the payment of the principal balance requiring us to pay the entire indebtedness outstanding on that date. From and after the maturity date of the credit facility, or any earlier date that all principal owing under the credit facility becomes due and payable by acceleration or otherwise, the outstanding principal balance will bear interest until paid in full at an increased rate per annum equal to 3% above the rate of interest in effect from time to time under the credit facility.

The credit facility also provides for a term loan of \$200,000 secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment, amortizable over 36 months at a variable rate equal to the prime rate plus 1%.

As of June 30, 2006, our foreign subsidiaries had credit facilities, including lines of credit and term loans, with Lloyds TSB Bank PLC ("Lloyds TSB") and Lloyds TSB Commercial Finance Limited ("Lloyds") in England, IFN Finance, a subsidiary of ABN AMRO Holdings, N.V., Banc National de Paris,

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Societe Generale in France, and Sogelease and Johnan Shinkin Bank in Japan. At June 30, 2006, the balances outstanding under our United Kingdom, France and Japan credit facilities were \$1,486,000, \$773,000 and \$24,000, respectively.

On July 8, 2005, XPS and Pascall obtained a 24-month credit facility with Lloyds, which facility expires July 31, 2007. At the same time, the credit facility of Venture Finance PLC, a subsidiary of ABN AMRO Holdings, N.V., was terminated and paid off. The Lloyds facility provides a revolving loan secured by receivables, with a maximum availability of 2,100,000 British pounds sterling (equivalent of U.S. \$3,813,000 based on the exchange rate in effect on June 30, 2006). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB base rate. The Lloyds TSB base rate was 4.5% at June 30, 2006. The financial covenants include a 50% cap on combined export gross sales of XPS and Pascall and days sales outstanding of less than 65 days, and the funding balance is capped at 125% of XPS and Pascall combined gross sales. As of June 30, 2006, the revolving loan had an outstanding balance of \$809,000.

On August 26, 2005, XPS entered into an agreement with Lloyds for an unsecured cashflow loan of 300,000 British pounds sterling (equivalent of U.S. \$545,000 based on the exchange rate in effect on June 30, 2006 payable over 12 months). The loan is structured as an overadvance on the previously negotiated 2,100,000 British pounds sterling revolving loan with Lloyds, bringing the maximum aggregate commitment on the revolving loan to 2,400,000 British pounds sterling (equivalent of U.S. \$4,358,000 based on the exchange rate in effect on June 30, 2006). As of June 30, 2006, the total outstanding balance was \$1,486,000 and is included in borrowings under lines of credit in the accompanying financial statements.

The unsecured cashflow loan of 300,000 British pounds sterling is payable at a rate of 25,000 British pounds sterling per month, the first payment falling due one month after initial drawdown on the revolving loan. The interest rate is variable and is adjusted monthly based on the base rate of Lloyds TSB plus 1.9%. The Lloyds TSB base rate at June 30, 2006 was 4.5%. Lloyds TSB has sole discretion to switch the details on this overadvance account if Lloyds determines that the Company will have difficulty in meeting the specific reductions in the overadvance account.

18

On August 26, 2005, EEL entered into an agreement with Lloyds TSB for an unsecured term loan for 500,000 British pounds sterling (equivalent to U.S. \$870,000 based on the exchange rate in effect on June 30, 2006). This loan is repayable in 36 consecutive monthly installments of principal and interest. The interest rate is variable and is adjusted daily based on the Lloyds TSB base rate plus 2.5%. The Lloyds TSB base rate at June 30, 2006 was 4.5%. The loan also includes financial covenants. EEL must maintain consolidated profit before taxation and interest paid and payable of no less than 500% of the consolidated interest paid and payable. Additionally, EEL must maintain consolidated profit before taxation, depreciation, amortization of goodwill and other intangibles and interest paid and payable of no less than 300% of the consolidated principal repayments and the consolidated interest paid and payable. As of September 30, 2006, the term loan had an outstanding balance of \$677,000.

In the event of a default, Lloyds TSB may make the loan, including any outstanding principal and interest which has accrued, repayable on demand. If any amount payable is not paid when due, EEL shall pay an increased interest rate per annum equal to 3% above the rate of interest in effect from time to time under the note.

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In April 2003, CXR-AJ obtained a credit facility from IFN Finance, a subsidiary of ABN AMRO N.V. This credit facility is for a maximum of \$1,449,000 based on the exchange rate in effect at June 30, 2006 for the conversion of euros into United States dollars. CXR-AJ also had \$66,000 of cash credit lines with several other banks and \$32,000 of term loans with another French bank outstanding as of March 31, 2006. The IFN Finance facility is secured by accounts receivable and carries an annual interest rate of 1.6% above the French "T4M" rate. At June 30, 2006, the French T4M rate was 2.6943%, and this facility had a balance of \$665,000. This facility has no financial performance covenants.

XCEL Japan Ltd., or XJL, obtained a term loan on November 29, 2002 from Johnan Shinkin Bank. The loan is amortized over five years, carries an annual fixed interest rate of 3.25% and is secured by the assets of XJL. The balances of the loan as of June 30, 2006 were \$24,000 as of June 30, 2006 for the conversion of Japanese Yen into U.S. Dollars, using the exchange rate in effect. There are no financial performance covenants applicable to this loan.

Our backlog was \$24,896,000 as of June 30, 2006 as compared to \$16,673,000 as of June 30, 2005. The increase in backlog of \$8,223,000 was primarily due to the increase of \$6,158,000 of backlog for XPS in the U.K., \$1,401,000 for Pascall in the U.K., and \$989,000 for RO, which was acquired in September 2005. Our backlog as of June 30, 2006 was 96.2% related to our electronic components business, which business tends to provide us with long lead-times for our manufacturing processes due to the custom nature of the products, and 3.8% related to our communications equipment business, which business tends to deliver standard products from stock as orders are received. The amount of backlog orders represents revenue that we anticipate recognizing in the future, as evidenced by purchase orders and other purchase commitments received from customers, but on which work has not yet been initiated or with respect to which work is currently in progress. However, there can be no assurance that we will be successful in fulfilling such orders and commitments in a timely manner or that we will ultimately recognize as revenue the amounts reflected as backlog.

As described above under the heading "Overview," we acquired Larus Corporation and Vista in July 2004. The \$6,539,500 purchase price consisted of \$1,000,000 in cash, the issuance of 1,213,592 shares of our common stock with a fair value of \$1,000,000, \$887,500 in the form of two short-term, zero interest promissory notes that were repaid in 2004, \$3,000,000 in the form of two subordinated secured promissory notes, warrants to purchase up to an aggregate of 150,000 shares of our common stock at \$1.30 per share, and approximately \$580,000 of acquisition costs. In addition, we assumed \$245,000 worth of accounts payable and accrued expenses and entered into an above-market seven-year real property lease with the sellers. This lease represents an obligation that exceeds the fair market value by approximately \$756,000 and is part of the acquisition accounting. We funded the cash portion of the purchase price using proceeds from our prior credit facility with Wells Fargo Bank and our cash on-hand.

19

On January 5, 2005, we issued to 17 accredited record holders in a private offering an aggregate of 12,503,500 shares of common stock at a purchase price of \$1.44 per share and five-year investor warrants to purchase up to an additional 3,125,875 shares of our common stock at an exercise price of \$1.73 per share, for a total purchase price of \$18,005,000. We paid cash placement agent fees and expenses of approximately \$961,000, and issued five-year placement warrants to purchase up to an aggregate of 650,310 shares of common stock at an exercise price of \$1.73 per share in connection with the offering. Additional costs related to the financing include registration rights-related

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liquidated damages of \$480,000 and legal, accounting and consulting fees that totaled approximately \$984,000 through December 31, 2005.

We agreed to register for resale the shares of common stock issued to investors and the shares of common stock issuable upon exercise of the investor warrants and placement warrants. The registration obligations require, among other things, that a registration statement be declared effective no later than June 4, 2005. We were unable to meet this obligation and therefore paid to each investor liquidated damages equal to 1% of the amount paid by the investor to us in the offering, which damage payments totaled an aggregate of approximately \$180,000. We also paid to the investors liquidated damages totaling \$300,000 for the period from June 5, 2005 through June 30, 2005, the date the registration statement was declared effective. We also will be required to pay to each investor liquidated damages for any future periods in which we are unable to maintain the effectiveness of the registration in accordance with the requirements contained in the registration rights agreement we entered into with the investors. These liquidated damages would be, and the liquidated damages paid for the period from June 5, 2005 through June 30, 2005 were, equal to 2% of the amount paid by each investor for the common shares still owned by the investor on each monthly anniversary of the date of the default that occurs prior to the cure of the default, pro rated on a daily basis for periods of default shorter than one month. The maximum aggregate liquidated damages payable to any investor will be equal to 10% of the aggregate amount paid by the investor for the shares of our common stock. Accordingly, the maximum aggregate penalty that we would be required to pay under this provision is 10% of the \$18,005,000 initial purchase price of the common stock, which would be \$1,801,000.

On May 5, 2006, our audit committee concluded that our financial statements for the years ended December 31, 2005 and 2004 and the interim periods during 2005 and 2004 should no longer be relied upon. The audit committee reached this conclusion after having discussions with our former independent registered public accountants and management as part of an investigation conducted by the audit committee in response to an inquiry by the staff of the Securities and Exchange Commission's Division of Enforcement. As a result of the audit committee's conclusion regarding our financial statements, on May 9, 2006, the registration statement was no longer effective. This event triggered the liquidated damages provision contained in the registration rights agreement. During the months of June through December 2006, we paid to the remaining investors liquidated damages in the aggregate amount of \$323,135.

We used a portion of the proceeds from the January 2005 private placement to fund the acquisition of Pascall. In connection with the Pascall acquisition, we loaned to EMRISE Electronics approximately \$10,100,000 in cash that was used to acquire Pascall and to repay Pascall's existing intercompany debt. As described above, the Pascall purchase price is subject to upward or downward adjustment, and accordingly we paid \$237,000 to Intelek on August 1, 2005 to compensate for an upward adjustment of Pascall's net worth. We have guaranteed obligations of EMRISE Electronics in connection with the Pascall acquisition and have agreed to indemnify Pascall's former parent in connection with obligations under Pascall's facilities lease.

We used another portion of the proceeds from the January 2005 private placement to partially fund the acquisition of RO. We used \$4,002,000 of cash to acquire RO, including paying down RO's bank debt of \$1,602,000. In addition, we agreed to make two deferred payments of \$300,000 each, the first of which we paid in October 2005, and the second of which was due on March 31, 2006.

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Offsetting these amounts was \$35,000 received from the former RO shareholders to compensate for balance sheet adjustments.

We included in our amended annual report on Form 10-K for the year ended December 31, 2005 a contractual obligations table that outlines payments due from us or our subsidiaries under our lines of credit and other significant contractual obligations through 2010, exclusive of interest. During the six months ended June 30, 2006, no material changes in this information occurred outside the ordinary course of business.

We intend to grow our business through both internal growth and further acquisitions that we identify as being potentially both synergistic and accretive of our earnings. Any additional acquisitions would likely be funded through the use of cash and/or a combination of cash and our stock.

We believe that current and future available capital resources, revenues generated from operations, and other existing sources of liquidity, including the credit facilities we have, will be adequate to meet our anticipated working capital and capital expenditure requirements for at least the next twelve months. If, however, our capital requirements or cash flow vary materially from our current projections, if unforeseen circumstances occur, or if we require a significant amount of cash to fund future acquisitions, we may require additional financing. Our failure to raise capital, if needed, could restrict our growth, limit our development of new products or hinder our ability to compete.

EFFECTS OF INFLATION

The impact of inflation and changing prices has not been significant on the financial condition or results of operations of either our company or our operating subsidiaries.

IMPACTS OF NEW ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4," SFAS No. 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period costs. The provisions of SFAS No. 151 are effective for our fiscal 2006. We are currently evaluating the provisions of SFAS No. 151 and do not expect that adoption will have a material effect on our financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. However, SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements. We do not believe our adoption of SFAS No. 154 will have a material effect on our consolidated financial position, results of operations or cash flows.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We have established and acquired international subsidiaries that prepare their balance sheets in the relevant foreign currency. In order to be included in our consolidated financial statements, these balance sheets are converted, at the then current exchange rate, into United States dollars, and the statements of operations are converted using weighted average exchange rates for the applicable period. Accordingly, fluctuations of the foreign currencies relative to the United States dollar could have an effect on our consolidated financial statements. Our exposure to fluctuations in currency exchange rates has increased as a result of the growth of our international subsidiaries. However, because historically the majority of our currency exposure has related to financial statement translation rather than to particular transactions, we do not intend to enter into, nor have we historically entered into, forward currency contracts or hedging arrangements in an effort to mitigate our currency exposure.

A substantial portion of our notes payable and long-term debt have variable interest rates based on the prime interest rate and/or the lender's base rate, which exposes us to risk of earnings loss due to changes in such interest rates. Our amended annual report on Form 10-K for the year ended December 31, 2005 contains information about our debt obligations that are sensitive to changes in interest rates under "Item 7A. Quantitative and Qualitative Disclosures About Market Risk." There were no material changes in those market risks during the six months ended June 30, 2006.

ITEM 4. CONTROLS AND PROCEDURES.

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

We conducted an evaluation, with the participation of our Chief Executive Officer and Acting Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, as of June 30, 2006, to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, including to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on that evaluation, our Chief Executive Officer and Acting Chief Financial Officer has concluded that as of June 30, 2006, our disclosure controls and procedures were not effective at the reasonable assurance level due to the material weaknesses described below.

A material weakness is a control deficiency (within the meaning of the Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2) or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In connection with its audit of our consolidated financial statements for the year ended December 31, 2005, Grant Thornton LLP ("GT"), our former independent registered public accounting firm, advised management and our audit committee of two matters that GT considered to be material weaknesses.

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GT indicated that in the area of accounting and financial reporting, it believed that we had insufficient accounting resources to enable us to identify and evaluate complex accounting and reporting matters. In addition, GT recommended that we establish procedures to ensure that our Chief Financial Officer can more closely monitor information submitted to our corporate headquarters by our subsidiary controllers and oversee accounting for reserves and other areas that involving significant judgment at all company locations. GT also recommended that we establish procedures to ensure that personnel familiar with accounting principles generally accepted in the United States and with Commission disclosure requirements thoroughly evaluate activities and transactions at all company locations in order to determine that we are timely making all required disclosures.

GT also indicated that we need to improve our controls over inventory reserves. GT noted that some items that were in our inventory reserve earlier in 2005 were not present in the year-end reserve, although those items remained in inventory at year end. Current accounting guidance would have required us to include in our year-end reserve all items that were included in the inventory reserve earlier in 2005, despite the fact that we no longer viewed those items as slow moving. Our failure to continue to include those items in the inventory reserve resulted in a material audit adjustment. In addition, GT determined that inventory reserves in our CXR-AJ location were understated at year-end, resulting in an additional audit adjustment.

In connection with its audit of our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003, Hein & Associates LLP ("Hein"), our independent registered public accounting firm, advised management and our audit committee that they concur with GT's assessment of the material weaknesses described above. Hein also noted that our accounting department did not provide us with the appropriate resources, adequate technical skills and supervision to accurately account for our revenues, as evidenced by our need to restate our 2005 and 2004 financial statements.

To initially address these material weaknesses, management performed additional analyses and other procedures to ensure that the financial statements included herein fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented.

REMEDIATION OF MATERIAL WEAKNESS

To remediate the material weakness in our disclosure controls and procedures identified above, we have done or intend to do the following, in the periods specified below:

To remediate the material weakness in the area of accounting and financial reporting identified by GT and Hein, during the second and third quarters of 2006 we sought, and we intend to seek in the future, additional guidance from our financial consultants, who are certified public accountants with the requisite background and experience to assist us in identifying and evaluating complex accounting and reporting matters. In addition, we intend to increase the frequency at which our Chief Financial Officer and our Director of Financial Controls for Europe visit and hold conference calls with accounting personnel and managers at each of our company locations. Also, we intend to define internal processes for identifying and disclosing non-routine and other transactions as required by Commission disclosure requirements and for researching and determining proper accounting treatment for those transactions. We plan to assign individuals with appropriate knowledge and skills to perform these processes and plan to provide those individuals with adequate technical resources to help ensure timely disclosure of the transactions and proper application of accounting principles generally accepted in the United States. During the second and third quarters of 2006, we developed procedures to

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document all non-routine transactions on a quarterly, including support for the final accounting treatment, and now require the assigned individuals to review the documentation with our Chief Financial Officer and/or Director of Financial Controls for Europe prior to finalizing our quarterly and annual financial statements.

23

In the third quarter of 2006, we developed plans to alter the current organization of our accounting department and to hire additional personnel to assist in our financial reporting processes. We seek to hire a Chief Financial Officer and a Controller, each with expertise in public company financial reporting compliance

We believe that a new Chief Financial Officer and a new Controller, once hired, will contribute additional expertise to our team of finance and accounting personnel and will assist us in our financial reporting processes. We believe that once our accounting department is strengthened through the addition of these additional staff members, we will have in place an adequate supervisory structure to ensure accurate accounting for and disclosure of all transactions in a timely manner.

Management is unsure, at the time of the filing of this report, when the actions described above will remediate the material weakness also described above. Although management intends to hire a new Chief Financial Officer and a new Controller as soon as practicable, it may take an extended period of time until suitable candidates can be located and hired. Management is, however, optimistic that these personnel can be located and hired by the end of the first quarter of 2007. Until we hire a new Chief Financial Officer and a new Controller, as planned, management may hire outside consultants to assist us in satisfying our financial reporting obligations.

Management believes that a new Chief Financial Officer will have an annual base salary in the range of \$185,000 to \$200,000 and a new Controller will have an annual base salary in the range of \$130,000 to \$150,000, not including benefits and other costs of employment. Management is unable, however, to estimate our expenditures related to fees paid or that may be paid in the future to financial consultants in connection with their guidance in identifying and evaluating complex accounting and reporting matters. Management is also unable to estimate our expenditures related to the development of new internal processes for identifying and disclosing both routine and non-routine transactions and for researching and determining proper accounting treatment for those transactions. Management is also unable to estimate our expenditures related to the hiring of other outside consultants to assist us in satisfying our financial reporting obligations. In addition, management is unable to estimate our expenditures related to higher fees to be paid to our independent auditors in connection with their review of this remediation.

To remediate the material weakness with regard to our controls over inventory reserves, we have adjusted the procedures we use to compute inventory reserves to ensure that items that are included in inventory reserves are not removed from inventory reserves until a sale or disposal of those items occurs.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

The changes noted above, specifically, the changes relating to our (i) efforts to locate suitable candidates for the positions of Chief Financial Officer and Controller, (ii) engaging of financial consultants who are certified public accountants to assist us in identifying and evaluating complex accounting

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and reporting matters, (iii) new internal processes for identifying and disclosing both routine and non-routine transactions and for researching and determining proper accounting treatment for those transactions, and (iv) assignment of individuals to perform these processes and provision to those individuals of technical and other resources to help ensure the proper application of accounting principles and the timely and appropriate disclosure of routine and non-routine transactions, are the only changes during our most recently completed fiscal quarter that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act.

24

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

We are not a party to any material pending legal proceedings.

ITEM 1A. RISK FACTORS.

Item 1A of Part I of our Amendment No. 1 to Form 10-K for the fiscal year ended December 31, 2005 summarizes various material risks that investors should carefully consider before deciding to buy or maintain an investment in our common stock. Any of those risks, if they actually occur, would likely harm our business, financial condition and results of operations and could cause the trading price of our common stock to decline. There are no material changes to the risk factors set forth in the above-referenced report.

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

DIVIDENDS

We have not declared or paid any cash dividends on our capital stock in the past, and we do not anticipate declaring or paying cash dividends on our common stock in the foreseeable future. In addition, our credit facility with WFBC, described in "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources," restricts the payment of dividends without the bank's consent.

We will pay dividends on our common stock only if and when declared by our board of directors. Our board of directors' ability to declare a dividend is subject to restrictions imposed by Delaware law. In determining whether to declare dividends, the board of directors will consider these restrictions as well as our financial condition, results of operations, working capital requirements, future prospects and other factors it considers relevant.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None.

ITEM 5. OTHER INFORMATION.

None.

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ITEM 6. EXHIBITS.

| NUMBER ----- | DESCRIPTION ----- |
|-----------------|--|
| 31.1 | Certification of Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32 | Certification of Chief Executive Officer and Acting Chief Financial Officer Pursuant to 18 U.S.C. Section 350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

25

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.

EMRISE CORPORATION

Dated: January 17, 2007

By: /s/ Carmine T. Oliva

Carmine T. Oliva, Chairman of the Board,
Chief Executive Officer (principal executive officer), President, Secretary and Acting
Chief Financial Officer (principal financial and accounting officer)

26

EXHIBITS ATTACHED TO THIS REPORT

| EXHIBIT NUMBER ----- | DESCRIPTION ----- |
|----------------------------|--|
| 31.1 | Certification of Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted |

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Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of Chief Executive Officer and Chief Financial Officer
Pursuant to 18 U.S.C. Section 350, as Adopted Pursuant to Section 906
of the Sarbanes-Oxley Act of 2002