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Emrise CORP
Form 10-Q
August 22, 2005

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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, 2005 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 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 an accelerated filer
(as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 12, 2005, there were 37,497,750 shares of the issuer's
common stock, \$0.0033 par value, outstanding.

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

Condensed Consolidated Balance Sheets (unaudited) as of June 30, 2005
and December 31, 2004.....

Condensed Consolidated Statements of Operations
(unaudited) for the Three and Six Months Ended June 30, 2005 and 2004

Condensed Consolidated Statements of Comprehensive Income (Loss)
(unaudited) for the Three and Six Months Ended June 30, 2005.....

Condensed Consolidated Statements of Stockholders' Equity (unaudited) for the
Six Months Ended June 30, 2005

Condensed Consolidated Statements of Cash Flows (unaudited) for the Six Months
Ended June 30, 2005 and 2004

Notes to Condensed Consolidated Financial Statements (unaudited).....

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

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

ITEM 4. CONTROLS AND PROCEDURES.....

PART II
OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.....

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.....

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

ITEM 5. OTHER INFORMATION.....

ITEM 6. EXHIBITS.....

SIGNATURES

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ITEM 1. FINANCIAL STATEMENTS

EMRISE CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	June 30, 2005
ASSETS	
Current assets:	
Cash and cash equivalents	\$ 6,435
Accounts receivable, net of allowance for doubtful accounts of \$156 and \$153, respectively	7,635
Inventories	8,596
Deferred tax assets	345
Prepaid and other current assets	573
Total current assets	23,584
Property, plant and equipment, net	2,079
Goodwill, net of accumulated amortization of \$1,074 and \$1,084, respectively	12,368
Intangible assets, net of accumulated amortization of \$135 and \$40, respectively	2,062
Other assets	573
	\$ 40,666
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Borrowings under lines of credit	\$ 811
Current portion of long-term debt	892
Notes payable to stockholders, current portion	500
Accounts payable	3,171
Income taxes payable	594
Accrued expenses	3,707
Total current liabilities	9,675
Long-term debt, less current portion	322
Notes payable to stockholders, less current portion	2,000
Deferred income taxes	1,420
Other liabilities	887
Total liabilities	14,304
Stockholders' equity:	
Common stock, \$0.0033 par value. Authorized 50,000,000 shares; issued and outstanding 37,385,000 and 24,777,000, respectively	123
Additional paid-in capital	43,243
Accumulated deficit	(16,735)
Accumulated other comprehensive income (loss)	(269)
Total stockholders' equity	26,362

\$ 40,666

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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, 2005 AND 2004
 (UNAUDITED)
 (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Three Months Ended June 30,		Six Months Ended June 30,
	2005	2004	2005
Net sales	\$ 9,962	\$ 6,432	\$ 17,261
Cost of sales	5,999	3,533	10,186
Gross profit	3,963	2,899	7,075
Operating expenses:			
Selling, general and administrative	3,447	2,067	6,278
Engineering and product development	604	312	1,136
Income (loss) from operations	(88)	520	(339)
Other income (expense):			
Interest expense	(94)	(94)	(196)
Interest income	37	--	109
Other income (expense)	115	(30)	112
Income (loss) before income taxes	(30)	396	(314)
Income tax expense (benefit)	(51)	27	15
Net income (loss)	\$ 21	\$ 369	\$ (329)
Basic earnings per share	\$ 0.00	\$ 0.02	\$ (0.01)
Diluted earnings per share	\$ 0.00	\$ 0.02	\$ (0.01)

See accompanying notes to condensed consolidated financial statements.

F-2

EMRISE CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME AND LOSS
 THREE AND SIX MONTHS ENDED JUNE 30, 2005 AND 2004
 (UNAUDITED)
 (IN THOUSANDS)

Three Months Ended
June 30,

Six Months
Ended
June 30,

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	2005	2004	2005
Net income (loss)	\$ 21	\$ 369	\$ (32)
Other comprehensive loss:			
Foreign currency translation adjustment	(315)	(62)	(75)
Comprehensive income (loss)	\$ (294)	\$ 307	\$ (1,08)

See accompanying notes to condensed consolidated financial statements.

F-3

EMRISE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
SIX MONTHS ENDED JUNE 30, 2005
(UNAUDITED)
(IN THOUSANDS)

	Common Stock		Additional Paid-In Capital	Accumulate Deficit
	Shares	Amount		
Balance at December 31, 2004	24,777	\$ 82	\$ 26,746	\$ (16,4
Stock option exercises	104	--	36	
Issuance of common stock and warrants	12,504	41	16,438	
Foreign currency translation adjustment	--	--	--	
Warrants issued for services	--	--	23	
Net loss	--	--	--	(3
Balance at June 30, 2005	37,385	\$ 123	\$ 43,243	\$ (16,7

See accompanying notes to condensed consolidated financial statements.

F-4

EMRISE CORPORATION AND SUBSIDIARIES
SIX MONTHS ENDED JUNE 30, 2005 AND 2004
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

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	2005

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income (loss)	\$ (32)
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:	
Depreciation and amortization	39
Provision for inventory obsolescence	82
Deferred taxes	2
Changes in operating assets and liabilities net of businesses acquired:	
Accounts receivable	1,60
Inventories	(46)
Prepaid and other assets	(10)
Accounts payable and accrued expenses	(2,28)

Cash provided by (used in) operating activities	(33)

CASH FLOWS FROM INVESTING ACTIVITIES:	
Net purchases of property, plant and equipment	(14)
Cash paid for acquisition of Pascall, net of cash acquired	(9,34)
Acquisition related costs	(28)

Cash used in investing activities	(9,77)

CASH FLOWS FROM FINANCING ACTIVITIES:	
Net repayments of current notes payable	(6)
Repayments of long-term debt	(32)
Proceeds from long-term debt	9
Net proceeds from issuance of common stock in offering	16,47
Proceeds from exercise of stock options	3

Cash provided by (used in) financing activities	16,21

Effect of exchange rate changes on cash	(73)
Net increase in cash and cash equivalents	5,37
Cash and cash equivalents at beginning of period	1,05

Cash and cash equivalents at end of period	\$ 6,43
	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:	
Cash paid during the period for:	
Interest	\$ 17
	=====
Income taxes	\$ 3
	=====

See accompanying notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2005 AND 2004 (UNAUDITED)

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION AND BUSINESS

Emrise Corporation (the "Company"), operates through three wholly-owned subsidiaries: Emrise Electronics Corporation (formerly XET Corporation ("Emrise Electronics")), CXR Larus Corporation ("CXR Larus"), and CXR-Anderson Jacobson ("CXR-AJ"). Emrise Electronics and its subsidiaries design, develop, manufacture and market digital and rotary switches, power supplies, radio frequency ("RF") and microwave components and subsystems, and subsystem assemblies. CXR Larus designs, develops, manufactures and markets network access and transmission products, communications test equipment, and network timing and synchronization products. CXR-AJ designs, develops, manufactures and markets network access and transmission products. The Company conducts its operations out of various facilities in the United States, England, France 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 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, 2005 and December 31, 2004 and the results of operations and cash flows for the related interim periods ended June 30, 2005 and 2004. 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 financial statements included in its 2004 annual report on Form 10-K.

STOCK-BASED COMPENSATION

The Company applies Accounting Principles Bulletin ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations in accounting for its employee stock-based compensation plans. Accordingly, no compensation cost is recognized for its employee stock option plans unless the exercise price of options granted is less than fair market value on the date of grant. The Company has adopted the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148 "Accounting for Stock-Based Compensation-Transition and Disclosure."

The following table sets forth the net income, net income available for common stockholders and earnings per share amounts for the periods presented as if the Company had elected the fair value method of accounting for stock options for all periods presented:

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EMRISE CORPORATION AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2005 AND 2004
 (UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income (loss):				
As reported	\$ 21,000	\$ 369,000	\$ (329,000)	\$
Add: Stock-based compensation expense included in reported net income, net of related tax effect	--	--	--	--
Deduct: Stock-based compensation expense determined under the fair value-based method	(47,000)	(34,000)	(94,000)	--
Pro forma	\$ 26,000	\$ 335,000	\$ (423,000)	\$
Basic earnings per share:				
As reported	\$ 0.00	\$ 0.02	\$ 0.01	\$
Add: Stock-based compensation expense included in reported net income, net of related tax effect	--	--	--	--
Deduct: Stock-based compensation expense determined under the fair value-based method	--	(0.01)	--	--
Pro forma	\$ 0.00	\$ 0.01	\$ 0.01	\$
Diluted earnings per share:				
As reported	\$ 0.00	\$ 0.02	\$ 0.01	\$
Add: Stock based compensation expense included in reported net income, net of related tax effect	--	--	--	--
Deduct: Stock-based compensation expensed determined under the fair value-based method	--	(0.01)	--	--
Pro forma	\$ 0.00	\$ 0.01	\$ 0.01	\$

The above calculations include the effects of all grants in the periods presented. Because options often vest over several years and additional awards are made each year, the results shown above may not be representative of the effects on net income or loss in future periods. The calculations were based on a Black-Scholes pricing model with the following assumptions: no dividend yield; expected volatility of 87% to 92%; risk-free interest rate of 3%; expected lives

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of 7 years.

DERIVATIVE FINANCIAL INSTRUMENTS

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, establishes accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset or a liability measured at its fair value. SFAS No. 133 also requires that changes in the derivative's fair value be recognized currently in

F-7

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

earnings unless specific hedge accounting criteria are met, and that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting. The Company currently uses derivatives to manage foreign currency rate risk.

One of the Company's United Kingdom subsidiaries conducts business in British pounds sterling and has a program that utilizes forward currency contracts denominated in United States dollars to offset the risk associated with the effects of currency exposure for sales in United States dollars. Under this program, increases or decreases in the subsidiary's foreign currency exposure are offset by gains or losses on the forward contracts, to mitigate the possibility of foreign currency transaction gains or losses. These forward contracts generally have terms of 90 days or less. The Company does not use these forward contracts for trading purposes. All outstanding foreign currency forward contracts used in this program are marked to market at the end of the period with unrealized gains and losses included in other income and expense.

Emrise Electronics also has a program that utilizes a forward currency contract denominated in British pounds sterling to offset the risk of intercompany loans to a United Kingdom subsidiary. Under this program, increases or decreases in the current portion of intercompany debt due to Emrise Electronics are offset by gains or losses on the forward contract, to mitigate the possibility of foreign currency transaction gains or losses. The forward contract currently expires in August 2005. The Company does not use this forward contract for trading purposes. The forward contract used in this program is marked to market at the end of the period with unrealized gains and losses included in other income and expense.

The Company's ultimate realized gain or loss with respect to currency fluctuations will depend on the currency exchange rates and other factors in effect as the contracts mature. Net foreign exchange transaction losses included in other income and expense in the accompanying consolidated statements of operations totaled \$36,000 for the six months ended June 30, 2005. There was no hedging in the year ended December 31, 2004.

F-8

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EMRISE CORPORATION AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2005 AND 2004
 (UNAUDITED)

(2) EARNINGS 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,	
	2005	2004	2005	2004
NUMERATOR:				
Net income (loss)	\$ 21	\$ 369	\$ (329)	\$ 439
Income (loss) attributable to common stockholders	\$ 21	\$ 369	\$ (329)	\$ 439
DENOMINATOR:				
Weighted average number of common shares outstanding during the period	37,385	23,482	37,017	23,481
Incremental shares from assumed exercises of warrants and options	1,254	826	--	871
Adjusted weighted average number of outstanding shares	38,639	24,308	37,017	24,352
Basic earnings per share	\$ 0.00	\$ 0.02	\$ (0.01)	\$ 0.02
Diluted earnings per share	\$ 0.00	\$ 0.02	\$ (0.01)	\$ 0.02

F-9

EMRISE CORPORATION AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2005 AND 2004
 (UNAUDITED)

The following options and warrants were excluded from the computation of diluted earnings per share as a result of the exercise prices exceeding the average market prices of the underlying shares of common stock (in thousands, except per share amounts):

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	Three Months Ended June 30,	
	2005	2004
Options and warrants to purchase shares of common stock	3,952	911
Exercise prices	\$1.55 - \$3.44	\$1.00 - \$3.44
	Six Months Ended June 30,	
	2005	2004
Options and warrants to purchase shares of common stock	6,147	1,129
Exercise prices	\$0.20 - \$3.44	\$1.00 - \$3.44

(3) INVENTORIES

Inventories consist of the following (in thousands):

	June 30, 2005	December 31, 2004
Raw materials	\$ 3,831	\$ 3,222
Work-in-process	2,099	1,280
Finished goods	2,666	1,989
	\$ 8,596	\$ 6,491

(4) 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.

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EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(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, 2005:

Reporting Units Within Electronic Components Segment:

- o Emrise Electronics - Rancho Cucamonga, California: Digitran Division- digital and rotary switches, and electronic subsystem assemblies for defense, aerospace and industrial applications
- o Emrise Electronics - Monrovia, California: XCEL Circuits Division - printed circuit boards mostly for intercompany use but with a small base of outside customers
- o XCEL Japan Ltd. - Tokyo, Japan: Reseller of Digitran switches and other third party electronic components
- o XCEL Corporation Ltd. - Ashford, Kent, England/Isle of Wight, England: Power supplies and radio frequency products for defense and aerospace applications and for a broad range of other commercial applications, including in-flight entertainment systems; this reporting unit also includes XCEL Power Systems, Ltd. ("XPS"), and Pascall Electronics Limited

Reporting Units Within Communications Equipment Segment:

- o CXR Larus - San Jose, California: Network timing and synchronization devices and network access equipment
- o CXR-AJ - Abondant, France: network access equipment and Transmission equipment.

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 2004 annual report on Form 10-K except for the inclusion of Pascall sales in the electronic components segment for the last 13 days of the three months ended March 31, 2005 and for the three months ended June 30, 2005. Selected financial data for each of the Company's operating segments is shown below (in thousands):

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EMRISE CORPORATION AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2005 AND 2004
 (UNAUDITED)

	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005
Sales to external customers:			
Electronic Components	\$ 6,421	\$ 3,955	\$ 10,227
Communications Equipment	3,541	2,477	7,034
	\$ 9,962	\$ 6,432	\$ 17,261
Segment pretax profits (losses):			
Electronic Components	\$ 660	\$ 813	\$ 1,177
Communications Equipment	(99)	141	(290)
	\$ 561	\$ 954	\$ 887

	June 30, 2005
Segment assets:	
Electronic Components	\$ 19,565
Communications Equipment	15,674
	\$ 35,239

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

	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005
Income before income taxes			
Total income for reportable segments	\$ 561	\$ 954	\$ 887
Unallocated amounts:			
General corporate expenses	(591)	(558)	(1,216)
Consolidated income before income taxes	\$ (30)	\$ 396	\$ (329)

	June 30, 2005
Assets	

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Total assets for reportable segments	\$	35,763
Other assets		4,903

Total consolidated assets	\$	40,666
		=====

(5) 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-12

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

(6) INCOME TAXES

The effective tax rate for the six-month period ended June 30, 2005 is different than the 34% United States statutory rate primarily because of foreign taxes on foreign source income that cannot be offset by domestic tax loss carryforwards.

(7) CREDIT FACILITIES

On June 1, 2004, two of the Company's subsidiaries, Emrise Electronics and CXR Larus, together with the Company acting as guarantor, obtained a credit facility from Wells Fargo Bank, N.A. for the Company's domestic operations. This facility was to be effective through July 1, 2005 and replaced the previous credit facility the Company had with Wells Fargo Business Credit, Inc. No prepayment penalty was due because the prior loan contract excluded from prepayment penalties loans replaced with new credit facilities from Wells Fargo Bank, N.A. The new credit facility 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 \$3,000,000 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 and the term loan described in the following paragraph exceed \$2,000,000 for 30 consecutive days (a "conversion event"). If a conversion event occurs, the line of credit will convert into a formula-based line of credit until the borrowings are equal to or less than \$2,000,000 for 30 consecutive days. The formula generally provides that outstanding borrowings under the line of credit may not exceed an aggregate of 80% of eligible accounts receivable, plus 15% of the value of eligible raw material inventory, plus 30% of the value of eligible finished goods inventory. The interest rate is variable and is adjusted monthly based on the prime rate plus 0.5%. The prime rate at June 30, 2005 was 6.25%.

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 \$100,000

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at June 30, 2005.

Wells Fargo Bank, N.A. has also provided the Company with \$300,000 of credit available for the purchase of new capital equipment when needed through July 1, 2005, of which a balance of \$135,000 was outstanding at June 30, 2005. The interest rate is equal to the 90-day London InterBank Offered Rate ("LIBOR") rate (3.52% at June 30, 2005) plus 3.75% per annum. Amounts borrowed under this arrangement are amortized over 60 months from the respective dates of borrowing.

As of June 30, 2005, the Company had no outstanding balance owing under the revolving credit line, and the Company had \$2,000,000 of availability on the non-formula based portion of the credit line. The credit facility is subject to various financial covenants. As of June 30, 2005, the Company was in compliance with each of those covenants. The minimum debt service coverage ratio of each of Emrise Electronics and CXR Larus must be not less than 1.50:1.00 on a trailing four-quarter basis. "Debt service coverage ratio" is defined as net income plus depreciation plus amortization, minus non-financed capital expenditures, divided

F-13

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

by current portion of long-term debt measured quarterly. The current ratio of each of Emrise Electronics and CXR Larus 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. Net income after taxes of each of Emrise Electronics and CXR Larus must be not less than \$1.00 on an annual basis, determined as of the end of each quarter. Net profit after taxes of each of Emrise Electronics and CXR Larus must be not less than \$1.00 in each fiscal quarter immediately following a fiscal quarter in which that entity incurred a net loss after taxes. Total liabilities divided by tangible net worth of our domestic operations on a consolidated basis must not at any time be greater than 2.00:1.00, determined as of each fiscal quarter end. Tangible net worth of us and all of our subsidiaries on a consolidated basis must not at any time be less than \$5,200,000, 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.

The credit facility was to expire July 1, 2005. However, the bank has extended the credit facility to September 1, 2005. The Company is in the process of renewing the credit facility. However, if the Company is unable to obtain a renewal of the credit facility, the Company believes that it will have sufficient funds available to timely repay any additional amounts it may borrow under the credit facility prior to the expiration of the extension.

As of June 30, 2005, the Company's foreign subsidiaries had credit facilities, including lines of credit and term loans, with Venture Finance PLC, a subsidiary of the global Dutch ABN AMRO Holdings, N.V. financial institution, 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, 2005, the balances outstanding under the Company's United Kingdom, France and Japan credit facilities were \$879,000, \$628,000 and \$44,000, respectively.

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On July 8, 2005, XPS and Pascall obtained a credit facility with Lloyds TSB Commercial Finance Limited ("Lloyds"). At the same time, the credit facility of Venture Finance PLC 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. \$3,822,000 based on the exchange rate in effect on June 30, 2005). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB rate. The Lloyds TSB rate was 4.75% at July 8, 2005. This credit facility covers a period of 24 months. The financial covenants include a 50% cap on combined export gross sales of XPS and Pascall and debt turns of less than 65 days, and the funding balance is capped at 125% of XPS and Pascall combined gross sales. In addition to the revolving loan, Lloyds has also indicated it is willing to provide an unsecured cashflow loan of \$546,000 and a \$273,000 term loan that will be secured by equipment and amortized over 36 months. The cashflow and term loan portions of the facility are being processed and are expected to close in the near future.

(8) RELATED PARTY TRANSACTIONS

On July 13, 2004, the Company issued two promissory notes to the former stockholders of Larus totaling \$3,000,000 in addition to paying cash and issuing shares of common stock (see Note 8), in exchange for 100% of the outstanding capital stock of Larus. These notes are subordinated to the Company's bank debt and are payable in 72 monthly equal payments of principal totaling \$41,667 per

F-14

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

month plus interest at the 30-day LIBOR rate 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. As of June 30, 2005, the 30-day LIBOR rate was 3.34%. The total balance of these promissory notes as of June 30, 2005 was \$2,500,000.

Future maturities of notes payable to stockholders are as follows:

Year Ending December 31, -----	Dollars in Thousands -----
2005 (6 months)	\$ 250
2006	500
2007	500
2008	500
2009	500
Thereafter	250

	\$ 2,500
	=====

Total interest paid on these notes for the six months ended June 30, 2005 was \$93,000.

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The Company entered into an above-market real property lease with the former stockholders of Larus Corporation. This lease represents an obligation that exceeds the fair market value by approximately \$756,000. The lease term is for 7 years and expires on June 30, 2011. It is renewable for a 5-year term priced under market conditions. The base rent is based on a minimum rent of \$0.90 per square foot per month, which is \$27,000 monthly or \$324,000 per year, subject to monthly adjustments of the interest rate based on the Federal Reserve Discount Rate that match the lessor's variable interest rate mortgage payments on the building. The maximum increase in any year is 1.5%, with a cumulative maximum increase of 8% over the life of the lease. The increases apply to that portion of the rent that corresponds to the interest portion of the lessor's mortgage. Lease payments paid to the related parties during the six months ended June 30, 2005 totaled \$184,000.

(9) 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 \$385,000 through June 30, 2005. The Company used a portion of the proceeds from this financing to fund the acquisition of Pascall in Note 10. The Company intends to use the remaining proceeds from this financing for additional acquisitions and for investments in new products and enhancements to existing products.

F-15

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

The Company 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. The Company was unable to meet this obligation and therefore paid to each investor liquidated damages equal to 1% of the amount paid by the investor to the Company in the offering, which damage payments totaled an aggregate of approximately \$180,000. The Company 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 was declared effective. These damages were charged directly to equity as a return of capital against the gross proceeds of the financing. The Company also will be required to pay to each investor liquidated damages for any future periods in which the Company is unable to maintain the effectiveness of the registration in accordance with the requirements contained in the registration rights agreement the Company entered into with the investors. These liquidated damages will be, and the liquidated

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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 the Company's common stock.

Accordingly, the maximum aggregate penalty that the Company 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 approximately \$1,801,000. Although the Company anticipates that it will be able to meet its future registration obligations, it also anticipates that it will have sufficient cash available to pay the maximum penalties if required.

(10) LARUS CORPORATION AND PASCALL 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 number of shares of the Company's common stock issued as part of the purchase price was calculated based on the \$0.824 per share average closing price of the Company's 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.

F-16

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

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. 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 determining the purchase price for Larus Corporation, the Company

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took into account the historical and expected earnings and cash flow of Larus Corporation, as well as the value of companies of a size and in an industry similar to Larus Corporation, comparable transactions and the market for such companies generally. The purchase price represented a significant premium over the \$1,800,000 recorded net worth of Larus Corporation's assets. In determining this premium, the Company considered the Company's potential ability to refine various Larus Corporation products and to use the Company's marketing resources and status as a qualified supplier to qualify and market those products for sale to large telecommunications companies. The Company believes that large telecommunications companies desired to have an additional choice of suppliers for those products and would be willing to purchase Larus Corporation's products following some refinements. The Company also believes that if Larus Corporation had remained independent, it was unlikely that it would have been able to qualify to sell its products to the large telecommunications companies due to its small size and lack of history selling to such companies. Therefore, Larus Corporation had a range of value separate from the net worth it had recorded on its books.

In conjunction with the 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 valuation analysis is complete. Accordingly, the Company has recorded the Larus Corporation trade name and trademark at \$750,000, the technology at \$1,150,000, and customer relationships at \$200,000. Goodwill associated with the Larus Corporation acquisition totals \$4,944,000. The Larus Corporation 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, \$40,000 and \$95,000 of amortization expenses were recorded and charged to administrative expense during the year ended December 31, 2004 and the six months ended June 30, 2005, respectively. Previously, management had estimated the intangibles of Larus Corporation to be \$2,800,000 for trademark and trade name, \$500,000 for technology, and \$300,000 for customer relationships. As a result, the balances were adjusted and \$50,000 of amortization expense was recorded to adjust the accumulated amortization to the revised intangible balances.

F-17

EMRISE CORPORATION AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2005 AND 2004
 (UNAUDITED)

The following table summarizes the unaudited assets acquired and liabilities assumed in connection with this acquisition:

	Dollars in Thousands

Current assets	\$ 2,460
Property, plant and equipment	90
Intangible assets other than goodwill	2,100
Goodwill	4,944

Total assets acquired	9,594
Current liabilities	(766)

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Deferred income taxes	(1,400)
Unfavorable lease obligation and other liabilities	(888)

Total liabilities assumed	(3,054)

Net assets acquired	\$ 6,540
	=====

The intangible assets other than goodwill consist of non-amortizable trade names with a carrying value of \$750,000, and technology and customer relationships with carrying values of \$1,150,000 and \$200,000, respectively, that are amortizable over ten years. Amortization for the intangibles subject to amortization as of June 30, 2005 is anticipated to be approximately \$135,000 per year for each of the next five years.

PASCALL ACQUISITION

On March 1, 2005, the Company and XCEL Corporation Limited, a second-tier wholly-owned subsidiary of the Company ("XCEL"), entered into an agreement ("Purchase Agreement") for XCEL 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 XCEL the funds that XCEL 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.

Under the Purchase Agreement, XCEL purchased all of the outstanding capital stock of PEHL, using funds loaned to XCEL 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.

F-18

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

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 2,650,000 British pounds sterling. As a result, the Company paid to Intelek Properties Limited 130,000 British pounds sterling (approximately U.S.

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\$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 XCEL under indemnity, tax or warranty provisions of the Purchase Agreement.

XCEL 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.

The Company and Intelek PLC have agreed to guarantee payment when due of all amounts payable by XCEL and Intelek Properties Limited, respectively, under the Purchase Agreement. The Company and XCEL agreed to seek to replace the guaranty that Intelek Properties Limited has given to Pascall's landlord with a guaranty by the Company, and XCEL has agreed to indemnify Intelek Properties Limited and its affiliates for damages they suffer as a result of any failure to obtain the release of the guarantee of the 17-year lease that commenced in May 1999. The leased property is a 30,000 square foot administration, engineering and manufacturing facility located off the south coast of England.

Intelek Properties Limited has agreed to various restrictive covenants that apply for various periods following the closing. The covenants include non-competition with Pascall's business, non-interference with Pascall's customers and suppliers, and non-solicitation of Pascall's employees. In conjunction with the closing, Intelek Properties Limited, Intelek PLC, XCEL, and the Company entered into a Supplemental Agreement dated March 18, 2005. The Supplemental Agreement provides, among other things, that an interest-free bridge loan of 200,000 British pounds sterling (approximately U.S. \$385,000 based on the exchange rate in effect on March 17, 2005) that was made by the seller to Pascall on March 17, 2005 would be repaid by Pascall by March 31, 2005. XCEL agreed to ensure that Pascall had sufficient funds to repay the bridge loan. The bridge loan was repaid in full by Pascall on the March 31, 2005 due date.

F-19

EMRISE CORPORATION AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2005 AND 2004
 (UNAUDITED)

The following table summarizes the unaudited assets acquired and liabilities assumed in connection with this acquisition, including \$615,000 in acquisition costs:

	Dollars in Thousands

Current assets.....	\$ 6,196
Property, plant and equipment.....	1,367
Intangibles, including goodwill.....	5,008

Total assets acquired.....	12,571
Current liabilities.....	(2,535)
Other liabilities.....	(80)

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Total liabilities assumed.....	(2,615)

Net assets acquired.....	\$ 9,956
	=====

The purchase price represented a significant premium over the recorded net worth of Pascall's assets. In determining to pay this premium, we considered various factors, including the opportunities that Pascall presented for us to add RF components and RF subsystem assemblies to our product offerings, the marketing resources of Pascall in the United States power supplies market, and expected synergies between Pascall's business and our existing power supplies business.

In conjunction with the acquisition of Pascall, the Company has selected a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The Company has 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 estimated that the Pascall trade name and trademark are valued at \$50,000. The Company has estimated that the covenants not to compete that were obtained from Pascall's former affiliates are valued at \$100,000 in light of public statements made by those affiliates indicating that they were, for strategic reasons, exiting the power supply business, which the Company believes result in a low probability that they would return to the power supply business absent the covenants not to compete. 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, XCEL Power Systems, Ltd., already sells 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.

Accordingly, the Company has estimated that the goodwill associated with the Pascall acquisition totaled \$4,958,000 as compared to the initial goodwill of \$4,571,000. The Pascall 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 covenants not to compete will be amortized over their three-year duration. The valuation of the identified intangible assets is expected to be completed during the quarter ending

F-20

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 AND 2004
(UNAUDITED)

September 30, 2005 and could result in changes to the value of these identified intangible assets and corresponding changes to the value of goodwill. However, the Company does not believe these changes will be material to its financial position or results of operations.

PRO FORMA RESULTS OF OPERATIONS

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The following table summarizes, on an unaudited pro forma basis, the combined results of operations of the Company, Larus Corporation and Pascall, as though the Larus Corporation and Pascall acquisitions occurred as of January 1, 2004. The pro forma amounts give effect to appropriate adjustments for interest expense and income taxes. The pro forma amounts presented are not necessarily indicative of future operating results (in thousands, except per share amounts).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Revenues	\$ 9,962	\$ 11,239	\$ 20,502	\$ 21,87
Net income	\$,21	\$ 251	\$ (165)	\$ 51
Earnings per share of common stock				
Basic	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.0
Diluted	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.0

(11) ACCRUED EXPENSES

Accrued expenses were as follows (in thousands):

	June 30, 2005	December 31, 2004
Accrued salaries	\$ 805	\$ 805
Accrued payroll taxes and benefits	654	491
Advance payments from customers	42	77
Other accrued expenses	2,206	1,641
Total accrued expenses	\$ 3,707	\$ 3,014

F-21

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;

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- 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 subsidiary, Pascall Electronics Limited ("Pascall");
- 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, 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 annual report on Form 10-K for the year ended December 31, 2004, 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.

2

OVERVIEW

Through our three wholly-owned operating subsidiaries, Emrise Electronics Corporation ("Emrise Electronics", formerly XET Corporation), CXR Larus Corporation ("CXR Larus") and CXR-Anderson Jacobson ("CXR-AJ"), 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
 - electronic power supplies
 - subsystem assemblies
 - radio frequency ("RF") components and subsystem assemblies
- o Communications Equipment

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- network access and transmission products
- network 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 59.2% and 62.3% of our total net sales during the six months ended June 30, 2005 and 2004, respectively. Sales of communications equipment and related services, primarily to private customer premises and public carrier customers, were 40.8% and 37.7% of our total net sales during the six months ended June 30, 2005 and 2004, respectively.

Sales of our electronic components segment increased \$2,367,000 (30.1%) for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. Excluding sales of \$3,730,000 from our new subsidiary, Pascall, which we acquired March 18, 2005, our electronic components segment sales declined \$1,363,000 (18.0%) for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004, primarily due to a \$1,504,000 (38.8%) decrease in net sales of power supplies manufactured by our XCEL Power Systems, Ltd. subsidiary that was primarily due to the delay of delivery requirements for the Eurofighter Typhoon aircraft.

We achieved a \$2,270,000 (47.6%) sales increase in our communications equipment segment for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. Excluding \$2,947,000 of sales by CXR Larus that are attributable to the business previously conducted by Larus Corporation that we acquired in July 2004, our communications equipment segment sales declined \$677,000 (14.2%) for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. This was primarily due to a continued low demand for our test equipment by the major United States telecommunications companies, a delay in continued shipments on a long-term United States government infrastructure program and delays in French military communications infrastructure programs. Of our subsidiaries, CXR Larus was the most affected by the telecommunications downturn, because CXR Larus had the greatest dependence on sales to United States public carriers and other public carriers.

3

We continue to reduce costs at CXR Larus by reducing its work force and increasing our sourcing of test equipment from offshore manufacturers that produce for lower prices than the previous cost incurred to manufacture in-house. Outsourcing of manufacturing to Asia was a primary reason we were able to increase our gross margin from 34% in 2002 to 67% in 2004 in our CXR Larus test equipment business, which resulted in an annual cost reduction of approximately \$1,372,000 during 2004. During the six months ended June 30, 2005, we began working toward establishing a similar arrangement for the manufacture of our network timing and synchronization products, which we anticipate will result in further improvements in our gross margin. We also reduced costs elsewhere in our communications equipment segment and lowered the breakeven point both in our United States and France operations through various cost-cutting methods, such as using offshore contract manufacturers, reducing facility rent expense by approximately \$150,000 on an annual basis as compared to the six months ended June 30, 2004, and downsizing our administrative office in Paris, France. At the end of 2004, we merged Larus Corporation with and into CXR Telcom Corporation to form CXR Larus Corporation, and we integrated their

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operations.

As described in our annual report on Form 10-K for the year ended December 31, 2004, we paid \$6,539,500 to acquire the outstanding common stock of Larus Corporation on July 13, 2004 and have consolidated the results of operations of Larus Corporation beginning from the date of acquisition, July 13, 2004. We are beginning to now benefit from increased sales of our French subsidiary's products in the United States market as a result of sales and marketing support for the French products by CXR Larus' United States-based sales and marketing staff, which has resulted in the securing of relationships with two new major United States-based distributors during the six months ended June 30, 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. During the three months ended June 30, 2005, we implemented further administrative, engineering and sales cost savings through staffing reductions of approximately \$750,000 on an annual basis. These staffing reductions related to eliminating redundancies in personnel, including ten sales, marketing and administrative positions and one engineering director and the former President of CXR Telcom Corporation.

On March 18, 2005, XCEL Corporation Ltd. ("XCEL") purchased all of the outstanding capital stock of Pascall Electronic (Holdings) Limited ("PEHL"), the parent holding company of Pascall, using funds loaned to XCEL by Emrise. 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 from XCEL 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 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, 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 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 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 XCEL under indemnity, tax or warranty provisions of the purchase agreement.

XCEL 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) 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 Pascall and PEHL to Intelek Properties Limited.

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We and Intelek PLC have agreed to guarantee payment when due of all amounts payable by XCEL and Intelek Properties Limited, respectively, under the PEHL purchase agreement. Emrise and XCEL have agreed to seek to replace the guaranty that Intelek Properties Limited has given to Pascall's landlord with a guaranty from us, and XCEL has agreed to indemnify Intelek Properties Limited and its affiliates for damages they suffer as a result of any failure to obtain the release of the guarantee of the 17-year lease that commenced in May 1999. The leased property is a 30,000 square-foot administration, engineering and manufacturing facility located off the south coast of England.

Intelek Properties Limited has agreed to various restrictive covenants that apply for various periods following the closing. The covenants include non-competition with Pascall's business, non-interference with Pascall's customers and suppliers, and non-solicitation of Pascall's employees. In conjunction with the closing, Intelek Properties Limited, XCEL, Intelek PLC and we entered into a Supplemental Agreement dated March 18, 2005. The Supplemental Agreement provides, among other things, that an interest-free bridge loan of 200,000 British pounds sterling (approximately U.S. \$385,400 based on the exchange rate in effect on March 17, 2005) that was made by Intelek Properties Limited to Pascall on March 17, 2005 would be repaid by Pascall by March 31, 2005. XCEL agreed to ensure that Pascall has sufficient funds to repay the bridge loan. The bridge loan was repaid in full by Pascall to the seller on the March 31, 2005 due date.

We have consolidated the results of operations of Pascall beginning from the date of acquisition, March 18, 2005. Based on current sales projections, we anticipate that the Pascall acquisition will be accretive to our earnings per share despite the associated expenses relating both to the payment of the purchase price and the operation and integration of the Pascall business. We expect to increase Pascall's sales to its existing customers in the United States and to sell Pascall's products to Emrise's existing customers as a result of our local presence and enhanced support from our United States-based sales and marketing staff. We plan to consolidate a number of administrative functions of our two United Kingdom-based subsidiary's operations into the Pascall facility, which we anticipate will result in significant administrative and facilities cost savings.

5

The following table summarizes the unaudited assets acquired and liabilities assumed in connection with this acquisition, including \$615,000 in acquisition costs:

	Dollars in Thousands -----
Current assets.....	\$ 6,196
Property, plant and equipment.....	1,367
Intangibles, including goodwill	5,008

Total assets acquired.....	12,571
Current liabilities.....	(2,535)
Other liabilities.....	(80)

Total liabilities assumed.....	(2,615)

Net assets acquired.....	\$ 9,956

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The purchase price represented a significant premium over the recorded net worth of Pascall's assets. In determining to pay this premium, we considered various factors, including the opportunities that Pascall presented for us to add RF components and RF subsystem assemblies to our product offerings, the marketing resources of Pascall in the United States power supplies market, and expected synergies between Pascall's business and our existing power supplies business.

The following table summarizes, on an unaudited pro forma basis, the combined results of operations of Emrise, Laurus Corporation and Pascall, as though the Laurus Corporation and Pascall acquisitions occurred as of January 1, 2004. The pro forma amounts give effect to appropriate adjustments for interest expense and income taxes. The pro forma amounts presented are not necessarily indicative of future operating results (in thousands, except per share amounts).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Revenues	\$ 9,962	\$ 11,239	\$ 20,502	\$ 21,873
Net income	\$ 21	\$ 251	\$ (165)	\$ 518
Earnings per share of common stock				
Basic	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.02
	=====	=====	=====	=====
Diluted	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.02
	=====	=====	=====	=====

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 these 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.

6

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 delivery of products has occurred or services have been rendered, no significant obligations

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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 customer requests and receives authorization to return a product, the request is accompanied by a purchase order for a replacement product.

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 network 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. Product returns during 2004 were less than \$1,000. 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 3.2% and 5.7% of net sales during the six months ended June 30, 2005 and the year ended December 31, 2004, 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. Demand for our products can fluctuate significantly. A significant increase in the demand for our products could result in a short-term increase in the cost of inventory purchases, while a significant decrease in demand could result in an increase in the amount of excess inventory quantities on hand.

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. In the future, if our inventory is determined to be overvalued, we would be required to recognize such costs in our cost of goods sold at the time of such determination. Likewise, if our inventory is determined to be undervalued, we may have over-reported our costs of goods sold in previous periods and would be required to recognize additional operating income at the time of sale. Therefore, 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 57.3% of our net revenues, 46.0% of our assets and 39.0% of our total liabilities as of and for the year ended December 31, 2004, and 61.2% of our net revenues, 54.2% of our assets and 48.7% of our total liabilities as of and for the six months ended June 30, 2005. 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 either included 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.

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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 a cumulative translation loss of \$269,000 and gain of \$487,000 that were included as part of accumulated other comprehensive income (loss) within our balance sheet at June 30, 2005 and December 31, 2004, respectively. During the six months ended June 30, 2005 and the year ended December 31, 2004, we included translation adjustments of losses of approximately \$756,000 and \$379,000, respectively, under accumulated other comprehensive income (loss).

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 loss for these periods. 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.

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 June 30, 2005 and December 31, 2004, the reported goodwill totaled \$12,368,000 and \$5,881,000, respectively (net of accumulated amortization of \$1,074,000 and \$1,084,000, respectively). During the six months ended June 30,

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2005 and the year ended December 31, 2004, we did not record any impairment losses related to goodwill and other intangible assets.

9

In conjunction with our July 2004 acquisition of Larus Corporation, we commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. As a result of the valuation, we have determined that the Larus trade name and trademark are valued at \$750,000, the technology is valued at \$1,150,000 and customer relationships are valued at \$200,000. Goodwill associated with the Larus Corporation acquisition totaled \$4,944,000. 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, \$40,000 and \$95,000 of amortization expenses were recorded and charged to administrative expense during the year ended December 31, 2004 and the six months ended June 30, 2005, respectively. Previously, management had estimated the intangibles of Larus Corporation to be \$2,800,000 for trademark and trade name, \$500,000 for technology, and \$300,000 for customer relationships. As a result, the balances were adjusted and \$50,000 of amortization expense was recorded to adjust the accumulated amortization to the revised intangible balances.

In conjunction with our March 2005 acquisition of Pascall, we have selected a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. We have considered whether the acquisition included various types of identifiable intangible assets, including trade names, trademarks, covenants not to compete, patents, customers, workforce, technology and software. We have estimated that the Pascall trade name and trademark are valued at \$50,000. We have estimated that the covenants not to compete that were obtained from Pascall's former affiliates are valued at \$100,000 in light of public statements made by those affiliates indicating that they were, for strategic reasons, exiting the power supply business, which we believe results in a low probability that they would return to the power supply business absent the covenants not to compete. 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, XCEL Power Systems, Ltd., already sells 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.

Accordingly, we have estimated that the goodwill associated with the Pascall acquisition totaled \$4,958,000 as compared to the initial goodwill of \$4,571,000. The Pascall 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 covenants not to compete will be amortized over their three-year duration. The valuation of the identified intangible assets is expected to be completed during the quarter ending September 30, 2005 and could result in changes to the value of these identified intangible assets and corresponding changes to the value of goodwill. However, we do not believe these changes will be material to our financial position or results of operations.

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RESULTS OF OPERATIONS

The tables presented below, which compare our results of operations for the three and six months ended June 30, 2005 to our results of operations for the three and six months ended June 30, 2004, present 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:

10

- 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.

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

	THREE MONTHS ENDED JUNE 30,		DOLLAR VARIANCE	PERCENT VARIA
	2005	2004	FAVORABLE (UNFAVORABLE)	FAVOR (UNFAVO
(DOLLARS IN THOUSANDS)				
Net sales				
Electronic components	\$ 6,421	\$ 3,955	\$ 2,466	6
Communications equipment	3,541	2,477	1,064	4
Total net sales	9,962	6,432	3,530	5
Cost of sales				
Electronic components	4,084	2,260	(1,824)	(8
Communications equipment	1,915	1,273	(642)	(5
Total cost of sales	5,999	3,533	(2,466)	(6
Gross profit				
Electronic components	2,337	1,695	642	3
Communications equipment	1,626	1,204	422	3
Total gross profit	3,963	2,899	1,064	3
Selling, general and administrative expenses	3,447	2,067	(1,380)	(6
Engineering and product development.....	604	312	(292)	(9
Operating income	(88)	520	(608)	(11

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Interest expense	(94)	(94)	--	
Interest income	37	--	37	
Other (income) expense	115	(30)	145	(48)
Income before income tax expense	(30)	396	(426)	(10)
Income tax expense	(51)	27	78	(28)
	-----	-----	-----	-----
Net income	\$ 21	\$ 369	(348)	(9)

NET SALES. The \$3,530,000 (54.9%) increase in total net sales for the three months ended June 30, 2005 as compared to the three months ended June 30, 2004 resulted from the combination of a \$2,466,000 (62.4%) increase in net sales of our electronic components and a \$1,064,000 (43.0%) increase in net sales of our communications equipment products and services.

ELECTRONIC COMPONENTS. The increase in net sales of our electronic components segment resulted from a \$1,366,000 (71.3%) increase in net sales of power supplies primarily due to the inclusion of \$2,042,000 of power supplies sold by Pascall, which we acquired on March 18, 2005. Without Pascall, sales of power supplies by XCEL Power Systems, Ltd. would have declined by \$676,000 primarily due to the delay of delivery requirements for the Eurofighter Typhoon aircraft. We first reported sales of RF components and RF subsystem assemblies

11

during the three months ended March 31, 2005. We had \$1,106,000 of sales of RF components and RF subsystems assemblies for the three months ended June 30, 2005 as compared to none in the prior year period due to the acquisition of Pascall. Sales of switches increased \$128,000 (8.5%) to \$1,639,000 for the three months ended June 30, 2005 from \$1,511,000 for the prior year period due to an \$81,000 increase in switch sales by XCEL Power Systems, Ltd. and a \$36,000 increase in switch sales by XCEL Japan, Ltd.

COMMUNICATIONS EQUIPMENT. The \$1,064,000 (43.0%) increase in net sales of our communications equipment segment resulted primarily from the inclusion in our results for the three months ended June 30, 2005 of \$1,437,000 of net sales of network timing and synchronization products attributable to our acquisition of Larus Corporation that occurred on July 13, 2004. This increase was partially offset by a \$199,000 (13.4%) decline in net sales of network access equipment and transmission products manufactured by CXR-AJ, which primarily was due to delays in the French military infrastructure programs. Communications test equipment net sales decreased \$154,000 (21.0%) to \$581,000 for the three months ended June 30, 2005 as compared to \$735,000 for the prior year period primarily due to a continued low demand by the major United States telecommunications companies and a delay in continued shipments on a long-term government infrastructure program due to customer technical issues. We anticipate that sales of our communications test equipment will remain flat throughout the remainder of 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 with whom we established relationships during the six months ended June 30, 2005. We also anticipate that sales of our network timing and synchronization products will show further growth as we build our business with telecommunications carrier companies in 2005 and beyond.

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GROSS PROFIT. Gross profit as a percentage of total net sales decreased to 39.8% for the three months ended June 30, 2005 from 45.1% for the prior year period. In dollar terms, gross profit increased by \$1,064,000 (36.7%) to \$4,411,000 for the three months ended June 30, 2005 as compared to \$2,899,000 for the prior year period.

ELECTRONIC COMPONENTS. The \$642,000 (37.9%) increase in gross profit for our electronic components segment was primarily due to the inclusion of Pascall's results, which contributed \$813,000 in gross profit for the three months ended June 30, 2005. The 2.9% percentage point decrease in gross profit as a percentage of total net sales of electronic components primarily resulted from the increased proportion of power supply sales resulting from the Pascall acquisition, which sales generally produce a lower gross margin than the switch products. Gross profit for our switch sales declined by \$74,000 (8.0%) to \$838,000 for the three months ended June 30, 2005 as compared to \$912,000 for the prior year period due to changes in product mix.

COMMUNICATIONS EQUIPMENT. The \$422,000 (35.0%) increase in gross profit for our communications equipment segment was primarily due to the inclusion of \$650,000 in gross profit during the three months ended June 30, 2005 attributable to net sales of network access and network timing and synchronization products that we did not offer prior to our acquisition of Larus Corporation in July 2004. Excluding the addition of these sales, gross profit for communications equipment decreased approximately \$228,000 (18.9%) primarily due to a \$235,000 (44.7%) decrease in gross profit of test equipment due to lower sales volume.

The 2.4 percentage point decrease in this segment's gross profit as a percentage of total net sales was primarily the result of the lower gross margin on sales of test equipment due primarily to lower sales volume.

12

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The \$1,380,000 (66.8%) increase in selling, general and administrative expenses for the three months ended June 30, 2005 as compared to the three months ended June 30, 2004 primarily was due to:

- o a \$142,000 (206%) increase in sales commissions primarily due to the inclusion of sales commissions due to the Larus and Pascall acquisitions;
- o a \$635,000 (97.5%) increase in other selling and marketing expenses primarily due to the inclusion of selling expenses as a result of the Larus and Pascall acquisitions, attendance at tradeshows, and increased advertising and marketing of our electronic components, including \$88,000 spent on trade shows;
- o a \$603,000 (44.8%) increase in administrative expenses primarily due to the inclusion of \$218,000 and \$217,000 of administrative costs for our Larus division and for Pascall, respectively;
- o an increase of \$70,000 in corporate legal expenses and a \$91,000 increase in accounting and auditing expenses at our United States operations to \$105,000 and \$142,000, respectively;

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- o a \$74,000 severance expense we recorded to administrative expense to reflect a consolidation of CXR Larus' operations; and
- o a \$55,000 expense we recorded for a repair provision for the building in Wales that we vacated to combine our coil winding business with XCEL Power Systems, Ltd. in Ashford, England.

Despite the increase in selling, general and administrative expenses in dollar terms, our selling general and administrative expenses declined to 31.9% of our net sales for the three months ended June 30, 2005 as compared to 32.1% of our net sales for the prior year period due to our overall increase in net sales.

We anticipate that selling, general and administrative expenses for the remainder of 2005 will remain at levels higher than those we experienced last year due to the Larus Corporation and Pascall acquisitions, increased investments in new products, sales and marketing expenses for our new low profile rotary and digital switches, 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. However we continue to seek efficiency and cost savings at all operations and anticipate we will further reduce our selling, general and administrative expenses by an estimated \$625,000 on an annual basis over the current levels as a result of sales, marketing and administrative staffing reductions implemented in our communications equipment segment during the three months ended June 30, 2005.

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of research and product development activities. The \$292,000 (93.6%) increase in these expenses resulted primarily from the inclusion of \$148,000 expenses attributable to our Larus division, a \$53,000 increase in research and engineering expenses related to our Pascall acquisition and a \$39,000 increase for development of our new low profile rotary switches. We expect this higher level of expense to continue throughout 2005 as we continue to develop our new family of rotary switches and pursue long-term opportunities in the timing and synchronization market. During the three months ended June 30, 2005, we eliminated one of our two engineering directors at CXR Larus, which we anticipate will offset approximately \$75,000 of our increased engineering expenses on an annual basis.

13

INTEREST EXPENSE AND OTHER INCOME. Interest expense of \$94,000 remained the same for the three months ended June 30, 2005 as for the three months ended June 30, 2004 due to the issuance of \$3,000,000 of notes for the acquisition of Larus Corporation in July 2004 which offset our lower bank interest charges. We recorded reduced interest expenses related to our Wells Fargo Bank loan and reduced loan balances of our United Kingdom operations. In addition, we recorded \$37,000 of interest income in the three months ended June 30, 2005, which was earned on the proceeds of the January 2005 private placement. We did not have interest income during the three months ended June 30, 2004. Other income of \$115,000 for the three months ended June 30, 2005 primarily was affected by a \$100,000 gain due to the sale of our T-Com product line for \$100,000. The T-Com Technology and tangible assets has no carrying value.

INCOME TAX EXPENSE. Income tax benefit for the three months ended June 30, 2005 was \$51,000, compared to an expense of \$27,000 for the three months

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ended June 30, 2004. We have net tax loss carryforwards for United States income tax purposes and our foreign subsidiaries achieved combined income before income taxes and corporate charges of \$196,000, which at the rates effective in the respective countries affect which tax loss carryforwards resulted in the reported current tax benefit of \$51,000.

NET INCOME. The net income for the three months ended June 30, 2005 decreased by \$348,000 (94.3%) to \$21,000 as compared to net income of \$369,000 for the three months ended June 30, 2004. The decrease was primarily due to the impact of planned increased sales and marketing expenses to launch new products and improve the marketing and sales efforts in promoting our existing products and the addition of similar expenses of Larus Corporation designed to increase future revenue and net income, together with the substantial increase in research and development associated primarily with our network timing products. We incurred severance expenses of \$119,000 for our CXR Larus integration, \$88,000 for trade shows, \$55,000 to provide for repairs due to the relocation of our Wales winding business to Ashford in the second quarter of 2005. We continue to closely monitor costs throughout our operations and have reduced costs through staffing reductions in our communications equipment operations in the United States as detailed above.

14

SIX MONTHS ENDED JUNE 30, 2005 COMPARED TO SIX MONTHS ENDED JUNE 30, 2004

	Six Months Ended JUNE 30,		DOLLAR VARIANCE	PERCENTAGE VARIANCE
	2005	2004	FAVORABLE (UNFAVORABLE)	FAVORABLE (UNFAVORABLE)
(DOLLARS IN THOUSANDS)				
Net sales				
Electronic components	\$ 10,227	\$ 7,860	\$ 2,367	30.1%
Communications equipment	\$ 7,034	\$ 4,764	\$ 2,270	47.6%
Total net sales	\$ 17,261	\$ 12,624	\$ 4,637	36.7%
Cost of sales				
Electronic components	\$ 6,451	\$ 4,525	\$ (1,926)	(42.6)%
Communications equipment	\$ 3,735	\$ 2,453	\$ (1,282)	(52.3)%
Total cost of sales	\$ 10,186	\$ 6,978	\$ (3,208)	(46.0)%
Gross profit				
Electronic components	\$ 3,776	\$ 3,335	\$ 441	13.2%
Communications equipment	\$ 3,299	\$ 2,311	\$ 988	42.8%
Total gross profit	\$ 7,075	\$ 5,646	\$ 1,429	25.3%
Selling, general and administrative expenses	\$ 6,278	\$ 4,284	\$ (1,994)	(46.5)%
Engineering and product development expenses	\$ 1,136	\$ 595	\$ (541)	(90.9)%
Operating income (loss)	\$ (339)	\$ 767	\$ (1,106)	(144.2)%

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Interest expense	\$ (196)	\$ (190)	\$ (6)	3.2%
Interest income	\$ 109	--	\$ 109	--
Other (income) expense	\$ 112	\$ (36)	\$ 148	(411.1)%
Income (loss) before income tax expense	\$ (314)	\$ 541	\$ (855)	(158.0)%
Income tax expense	\$ 15	\$ 102	\$ 87	(85.3)%
Net income (loss)	\$ (329)	\$ 439	\$ (768)	(174.9)%

NET SALES. The \$4,637,000 (36.7%) increase in total net sales for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004 resulted from the combination of a \$2,367,000 (30.1%) increase in net sales of our electronic components and a \$2,270,000 (47.6%) increase in net sales of our communications equipment products and services.

ELECTRONIC COMPONENTS. The increase in net sales of our electronic components segment resulted primarily from the inclusion in our results for the six months ended June 30, 2005 of Pascall's \$3,736,000 sales of power supplies and RF components and RF subsystem assemblies. This increase was offset by a \$1,504,000 (38.8%) decrease in sales at XCEL Power Systems, Ltd., which decrease was primarily related to reduced sales of power supplies primarily due to the delay of delivery requirements for the Eurofighter Typhoon aircraft. Sales of switches increased \$113,000 (3.8%) to \$3,113,000 for the six months ended June 30, 2005 from \$3,000,000 for the prior year period due to a \$173,000 increase of sales of our new low profile rotary switches partially offset by a \$60,000 decrease in digital switch sales.

We first reported sales of RF components and RF subsystem assemblies during the three months ended March 31, 2005 due to the Pascall acquisition. Excluding sales by Pascall from March 18, 2005 through June 30, 2005, our electronic components segment sales declined by \$1,363,000 or 17.3% for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. We currently anticipate that our sales of electronic components will increase in subsequent quarters of 2005, with the greatest anticipated period of growth occurring in late 2005 and throughout 2006 based upon informal indications we have received from various customers.

15

COMMUNICATIONS EQUIPMENT. The \$2,270,000 (47.6%) increase in net sales of our communications equipment segment resulted primarily from the inclusion in our results for the six months ended June 30, 2005 of \$2,947,000 of net sales of network timing and synchronization products attributable to our acquisition of Larus Corporation that occurred on July 13, 2004. This increase was partially offset by a \$538,000 (17.8%) decline in net sales of network access equipment and transmission products manufactured by CXR-AJ, which was primarily due to delays in the French military communications infrastructure programs. Communications test equipment net sales declined \$137,000 (11.3%) to \$1,080,000 for the six months ended June 30, 2005 as compared to \$1,217,000 for the prior year period, primarily due to a continued low demand by the major United States telecommunications companies. We anticipate that sales of our communications test equipment will remain flat throughout the remainder of 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

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United States-based distributors we established relationships with during the three months ended March 31, 2005. We also anticipate that sales of our network timing and synchronization products will show further growth as we build our business with telecommunications companies in 2005 and beyond.

GROSS PROFIT. Gross profit as a percentage of total net sales decreased to 41.0% from 44.7% for the prior year period. In dollar terms, gross profit increased by \$1,429,000 (25.3%) to \$7,075,000 for the six months ended June 30, 2005 as compared to \$5,646,000 for the prior year period.

ELECTRONIC COMPONENTS. The \$441,000 (13.2%) increase in gross profit for our electronic components segment was primarily due to the inclusion in our results for the six months ended June 30, 2005 of \$991,000 of gross profit from Pascall. Partially offsetting this increase was a \$325,000 reduction in gross profit from switches primarily due to product mix and a \$234,000 decrease in gross profit on power supplies produced by XCEL Power Systems, Ltd. as a direct result of reduced sales volume due to contract delivery deferrals. We expect overall sales of power supplies in 2005 to exceed overall sales of power supplies in 2004 and to grow further in 2006 based upon informal indications we have received from various customers.

COMMUNICATIONS EQUIPMENT. The \$988,000 (42.8%) increase in gross profit for our communications equipment segment was primarily due to the inclusion of \$1,325,000 in gross profit during the six months ended June 30, 2005 attributable to net sales of network access and network timing and synchronization products that we did not offer prior to our acquisition of Larus Corporation in July 2004. Excluding the addition of these sales, gross profit for communications equipment decreased approximately \$337,000 (14.6%) primarily due to a \$213,000 (24.0%) decrease in gross profit on test equipment due to lower sales volume and a \$123,000 (8.6%) reduction in gross profit at CXR-AJ for network access equipment sales due to lower volume.

The 0.8 percentage point decrease in this segment's gross profit as a percentage of total net sales was primarily the result of the larger contribution of the lower margin CXR Larus network timing and synchronization products and CXR-AJ network access products as compared to the higher margin test equipment.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The \$1,994,000 (46.5%) increase in selling, general and administrative expenses for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004 and the 2.5 percentage point increase in selling, general and administrative expenses as a percentage of total net sales were primarily due to:

16

- o a \$170,000 (84.2%) increase in sales commissions primarily due to the inclusion of \$109,000 and \$92,000 of sales commission expenses of our Larus division and Pascall, respectively;
- o a \$996,000 (74.6%) increase in other selling and marketing expenses primarily due to the inclusion of \$671,000 and \$353,000 of selling expenses of our Larus division and Pascall, respectively, attendance at tradeshows and increased advertising and marketing of our electronic components;
- o an \$829,000 (30.2%) increase in administrative expenses primarily due to the inclusion of \$385,000 and \$246,000 of

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administrative costs for our Larus division and Pascall, respectively;

- o \$53,000 in administrative expenses relating to our review of internal controls pursuant to Section 404 of the Sarbanes Oxley Act of 2002;
- o \$74,000 in severance costs we recorded to administrative expense to reflect a consolidation of CXR Larus' operations;
- o a \$55,000 expense we recorded for a repair provision for the building in Wales that we vacated to combine our coil winding business with XCEL Power Systems, Ltd. in Ashford, England; and
- o an increase of \$94,000 in United States corporate legal expenses and a \$92,000 increase in our domestic accounting and auditing expenses.

We anticipate that selling, general and administrative expenses for the remainder of 2005 will remain at levels higher than those we experienced last year due to the Larus Corporation and Pascall 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. However we continue to seek efficiency and cost savings at all operations and anticipate we will further reduce our selling, general and administrative expenses by an estimated \$625,000 on an annual basis over the current levels as a result of sales, marketing and administrative staffing reductions implemented in our communications equipment segment.

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of product development engineering activities. The \$541,000 (90.9%) increase in these expenses resulted primarily from the inclusion of \$337,000 expenses attributable to our Larus division and a \$96,000 increase in engineering attributable to Pascall. Also, expenses related to development of our new low profile rotary switches increased \$68,000 (31.9%) to \$281,000 for the six months ended June 30, 2005 as compared to \$213,000 for the prior year period. We expect this higher level of expense to continue throughout 2005 as we continue to develop our new family of rotary switches and pursue long -term opportunities in the timing and synchronization market. During the six months ended June 30, 2005, we eliminated one of our two engineering directors at CXR Larus, which we anticipate will offset approximately \$75,000 of our increased engineering expenses on an annual basis.

17

INTEREST EXPENSE AND OTHER INCOME. Interest expense increased by \$6,000 (3.2%) to \$196,000 for the six months ended June 30, 2005 as compared to \$190,000 for the six months ended June 30, 2004 primarily due to the issuance of \$3,000,000 of notes for the acquisition of Larus Corporation in July 2004. This increase was mostly offset by reduced interest expenses related to our Wells Fargo Bank loan and reduced loan balances of our United Kingdom operations. In addition, we recorded \$109,000 of interest income in the six months ended June 30, 2005, which was earned on the proceeds of the January 2005 private placement. We did not have interest income during the six months ended June 30,

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2004. Other income of \$112,000 for the six months ended June 30, 2005 primarily was affected by a \$100,000 gain due to the sale of our T-Com product line for \$100,000. The T-Com technology and tangible assets had no carrying value.

INCOME TAX EXPENSE. Income tax expense for the six months ended June 30, 2005 was \$15,000, compared to \$102,000 for the six months ended June 30, 2004 due to lower pretax income. Although we applied net tax loss carryforwards for United States income tax purposes, our foreign subsidiaries achieved combined income before income taxes and corporate charges of \$395,000, which at the rates effective in the respective countries resulted in the reported current tax expense of \$15,000.

NET INCOME (LOSS). Net income for the six months ended June 30, 2005 decreased by \$768,000 to a loss of \$329,000 as compared to net income of \$439,000 for the six months ended June 30, 2004. The decrease was primarily due to the impact of planned increased sales and marketing expenses to launch new products and improve the marketing and sales efforts in promoting our existing products and the addition of similar expenses of Larus Corporation designed to increase future revenue and net income together with the substantial increase in product development engineering associated primarily with our network timing and synchronization products. We continue to closely monitor costs throughout our operations and have reduced costs through staffing reductions in our communications equipment operations in the United States and France as detailed above.

LIQUIDITY AND CAPITAL RESOURCES

During the year ended December 31, 2004, 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, 2005, we continued to rely on these sources and also raised approximately \$16,437,000 in net proceeds through a private placement of equity securities in January 2005 as described below. As of June 30, 2005, we had working capital of \$13,909,000, which represented a \$8,369,000 (151.1%) increase from working capital of \$5,540,000 at December 31, 2004, primarily due to the proceeds from the private placement and the addition of the working capital of Pascall. At June 30, 2005 and December 31, 2004, we had accumulated deficits of \$16,735,000 and \$16,406,000, respectively, and cash and cash equivalents of \$6,435,000 and \$1,057,000, respectively.

Accounts receivable increased \$1,839,000 (31.7%) during the six months ended June 30, 2005 from \$5,796,000 as of December 31, 2004 to \$7,635,000 as of June 30, 2005. Sales attributable to the Pascall acquisition contributed \$2,236,000 to accounts receivable at June 30, 2005. Without the acquisition of Pascall, our receivables would have decreased \$397,000 (6.8%) during the six months ended June 30, 2005, primarily due to increased collections. Days sales outstanding, which is a measure of our average accounts receivable collection period, decreased from 69 days for the year ended December 31, 2004 to 55 days for the six months ended June 30, 2005. This calculation is skewed because \$2,236,000 of Pascall receivables were included in our accounts receivable balance at June 30, 2005 while only 105 days of Pascall's sales, totaling \$3,730,000, were included in our results for the six months ended June 30, 2005.

Excluding Pascall's sales, days sales outstanding was 61, which represents an improvement for the six month period as compared to 69 days sales outstanding for the year ended December 31, 2004. Our customers include many Fortune 100

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companies in the United States and similarly large companies in Europe and Asia. Because of the financial strength of our customer base, we have virtually eliminated our bad debt reserves.

Inventory balances increased \$2,105,000 (32.4%) during the six months ended June 30, 2005, from \$6,491,000 at December 31, 2004 to \$8,596,000 at June 30, 2005. Inventory represented 21.1% and 25.9% of our total assets as of June 30, 2005 and December 31, 2004, respectively. Included in the June 30, 2005 amount is \$2,117,000 of inventory attributable to Pascall. Excluding the effect of this inclusion, inventory would have decreased by \$12,000 and would have represented 18.8% of total assets (excluding the \$11,333,000 of total assets related to Pascall) at June 30, 2005. Inventory turnover, which is a ratio that indicates how many times our inventory is sold and replaced over a specified period, increased to 2.37 times (excluding Pascall, turnover would have decline to 2.3 times) for the six months ended June 30, 2005 as compared to 2.48 times for the year ended December 31, 2004 due to the decline in sales revenues.

We took various actions to reduce costs in 2004. These actions were intended to reduce the cash outlays of our communications equipment segment to match its revenue rate. We also have contracted with offshore manufacturers for production of test equipment at lower prices than we previously cost for in-house manufacturing. 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 \$330,000 for the six months ended June 30, 2005 as compared to cash provided by operating activities of \$980,000 for the six months ended June 30, 2004. This \$1,310,000 decrease in operating cash flows primarily resulted from a small net loss in the six months ended June 30, 2005 as compared to net income in the comparable period in the prior year, as well as increased payment of accounts payable and accrued expenses.

Cash used in our investing activities totaled \$9,776,000 for the six months ended June 30, 2005 as compared to \$186,000 for the six months ended June 30, 2004. Included in the results for the six months ended June 30, 2005 are net cash of \$9,341,000 used to acquire Pascall and \$149,000 of property, plant and equipment purchases for production equipment and computer equipment. The investments for the six months ended June 30, 2004 were mostly property, plant and equipment purchases.

Cash provided by our financing activities totaled \$16,216,000 for the six months ended June 30, 2005 as compared to \$443,000 of cash used in our financing activities for the six months ended March 31, 2004. The change is primarily due to the net proceeds of \$16,216,000 from the issuance of common stock in the January 2005 private placement.

On June 1, 2004, Emrise Electronics and CXR Larus, together with Emrise acting as guarantor, obtained a credit facility from Wells Fargo Bank, N.A. for our domestic operations. This facility was to be effective through July 1, 2005 and replaced the previous credit facility we had with Wells Fargo Business Credit, Inc. No prepayment penalty was due because the prior loan contract excluded from prepayment penalties loans replaced with new credit facilities from Wells Fargo Bank, N.A. The new credit facility 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 \$3,000,000 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 and the term loan described in the following paragraph exceed \$2,000,000

for 30 consecutive days (a "conversion event"). If a conversion event occurs, the line of credit will convert into a formula-based line of credit until the borrowings are equal to or less than \$2,000,000 for 30 consecutive days. The formula generally provides that outstanding borrowings under the line of credit may not exceed an aggregate of 80% of eligible accounts receivable, plus 15% of the value of eligible raw material inventory, plus 30% of the value of eligible finished goods inventory. The interest rate is variable and is adjusted monthly based on the prime rate plus 0.5%. The prime rate at June 30, 2005 was 6.25%.

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 \$112,000 at June 30, 2005.

Wells Fargo Bank, N.A. has also provided us with \$300,000 of credit available for the purchase of new capital equipment when needed through July 1, 2005, of which a balance of \$135,000 was outstanding at June 30, 2005 and July 1, 2005. The interest rate is equal to the 90-day London InterBank Offered Rate ("LIBOR") rate (3.52% at June 30, 2005) plus 3.75% per annum. Amounts borrowed under this arrangement are amortized over 60 months from the respective dates of borrowing.

The previous credit facility bore interest at the prime rate plus 1.0% and was subject to a \$13,500 minimum monthly interest fee plus an unused commitment fee equal to 0.25% per annum. The average amounts outstanding on the revolving portions of the previous and new credit facilities during the year ended December 31, 2004 and the six months ended June 30, 2005 were \$1,035,000 and zero dollars, respectively. The prime rate averaged approximately 4.25% in 2004 and approximately 5.625% during the six months ended June 30, 2005. During the six months ended June 30, 2005, interest on the new revolving line of credit totaled approximately \$12,000. During the six months ended June 30, 2004, interest on our previous domestic credit facility was \$76,000 and was subject to a minimum monthly interest charge of \$13,500.

At June 30, 2005, we had no outstanding balance owing under the revolving credit line and we had \$2,000,000 of availability on the non-formula based portion of the credit line. The credit facility is subject to various financial covenants. At June 30, 2005, we were in compliance with those financial covenants. The minimum debt service coverage ratio of each of Emrise Electronics and CXR Larus must be not less than 1.50:1.00 on a trailing four-quarter basis. "Debt service coverage ratio" is defined as net income plus depreciation plus amortization, minus non-financed capital expenditures, divided by current portion of long-term debt measured quarterly. The current ratio of each of Emrise Electronics and CXR Larus 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. Net income after taxes of each of Emrise Electronics and CXR Larus must be not less than \$1.00 on an annual basis, determined as of the end of each quarter. Net profit after taxes of each of Emrise Electronics and CXR Larus must be not less than \$1.00 in each fiscal quarter immediately following a fiscal quarter in which that entity incurred a net loss after taxes. Total liabilities divided by tangible net worth of our domestic operations on a consolidated basis must not at any time be greater than 2.00:1.00, determined as of each fiscal quarter end. Tangible net worth of us and all of our subsidiaries on a consolidated basis must not at any time be less than \$5,200,000, measured at the end of each quarter. "Total liabilities" is defined as current liabilities plus non-current liabilities,

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minus subordinated debt. "Tangible net worth" is defined as stockholders' equity plus subordinated debt, minus intangible assets.

20

At June 30, 2005, there was no balance outstanding under the revolving line of credit. The credit facility was to expire July 1, 2005. However, the bank extended the term of the revolving line to September 1, 2005 and has indicated that it intends to renew and expand the credit facility. However, if we are unable to obtain a renewal of the credit facility, we believe we will have sufficient funds available to timely repay any additional amounts we may borrow under the credit facility prior to the expiration of the extension.

On July 13, 2004, we 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 we repaid in 2004, in exchange for 100% of the capital stock of Larus Corporation. These notes are subordinated to our bank debt and are payable in 72 equal monthly payments of principal totaling \$41,667 per month plus interest at the 30-day LIBOR rate 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. As of June 30, 2005, the 30-day LIBOR rate was 3.33%. The total balance on these promissory notes as of June 30, 2005 was \$2,500,000.

As of June 30, 2005, our foreign subsidiaries had credit facilities, including lines of credit and term loans, with Venture Finance PLC, a subsidiary of the global Dutch ABN AMRO Holdings, N.V. financial institution, 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. As of June 30, 2005, the balances outstanding under our United Kingdom, France and Japan credit facilities were \$879,000, \$628,000 and \$44,000, respectively.

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 balance of the loan as of June 30, 2005 was \$44,000 using the exchange rate in effect at that date for conversion of Japanese yen into United States dollars. There are no financial performance covenants applicable to this loan.

XCEL Power Systems, Ltd., one of our United Kingdom subsidiaries, obtained a credit facility with Venture Finance PLC in November 2002. This credit facility expires on November 15, 2005. Using the exchange rate in effect at June 30, 2005 for the conversion of British pounds sterling into United States dollars, the facility is for a maximum of \$2,730,000 and includes a \$637,000 unsecured cash flow loan, a \$146,000 term loan secured by fixed assets, and the remainder is a loan secured by accounts receivable and inventory. The interest rate is the base rate of Venture Finance PLC (4.5% at June 30, 2005) plus 2%, and is subject to a minimum rate of 4% per annum. There are no financial performance covenants applicable to this credit facility.

On July 8, 2005, XPS and Pascall obtained a credit facility with Lloyds TSB Commercial Finance Limited ("Lloyds"). At the same time, the credit facility of Venture Finance PLC 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 of 2,100,000 British pounds sterling (approximately \$3,822,000 based on the exchange rate in effect on June 30, 2005). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB rate. The Lloyds TSB rate was

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4.75% at July 8, 2005. This credit facility covers a period of 24 months. The financial covenants include a 50% cap on combined export gross sales of XPS and Pascall and debt turns of less than 65 days, and the funding balance is capped at 125% of XPS and Pascall combined gross sales. In addition to the revolving loan, Lloyds has also indicated it is willing to provide an unsecured cashflow loan of \$546,000 and a \$273,000 term loan that will be secured by equipment and amortized over 36 months. The cashflow and term loan portions of the facility are being processed and are expected to close in the near future.

21

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 \$1,547,000, based on the exchange rate in effect at June 30, 2005 for the conversion of euros into United States dollars. CXR-AJ also had \$39,000 of term loans with several French banks outstanding as of June 30, 2005. 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, 2005, the French T4M rate was 2.067% and this facility had a balance of \$588,000. This facility has no financial performance covenants.

Our backlog was \$16,673,000 as of June 30, 2005 as compared to \$8,403,000 as of June 30, 2004. The increase in backlog was primarily due to the addition of \$8,405,000 of backlog for Pascall. Our backlog as of June 30, 2005 was 93.4% 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 6.6% 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. As a result of the acquisition, we acquired all of the assets and liabilities of Larus Corporation, including the intellectual property, cash, accounts receivable and inventories owned by each of Larus Corporation and Vista. 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 credit facility with Wells Fargo Bank, N.A. and our cash on-hand.

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

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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 liquidated damages and legal, accounting and consulting fees that totaled \$607,000 through June 30, 2005 and continue to be incurred in connection with the resale registration described below.

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

22

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 will 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. Although we anticipate that we will be able to meet our future registration obligations, we also anticipate that we will have sufficient cash available to pay the maximum penalties if required.

We used a portion of the proceeds from the January 2005 private placement to fund the acquisition of Pascall described above under the heading "Overview." In connection with the Pascall acquisition, we loaned to XCEL Corporation Ltd. 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 we have guaranteed obligations of XCEL Corporation Ltd. in connection with the Pascall acquisition and have agreed to indemnify Pascall's former parent in connection with obligations under Pascall's facilities lease. This has been settled with our \$237,000 payment to Inteltek on August 1 to compensate for an upward adjustment of Pascall's net worth.

We included in our annual report on Form 10-K for the year ended December 31, 2004 a contractual obligations table that outlines payments due from us or our subsidiaries under our lines of credit and other significant contractual obligations through 2009, exclusive of interest. During the six months ended June 30, 2005, no material changes in this information occurred outside the ordinary course of business.

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We intend to grow our business through both internal growth and through 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, notes and our limited use 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 and the remaining proceeds we have from the January 2005 private placement, 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.

23

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 December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which addresses the accounting for employee stock options. SFAS No. 123(R) eliminates the ability to account for shared-based compensation transactions using APB Opinion No. 25 and generally would require instead that such transactions be accounted for using a fair value-based method. SFAS No. 123(R) also requires that tax benefits associated with these share-based payments be classified as financing activities in the statement of cash flow rather than operating activities as currently permitted. SFAS No. 123(R) becomes effective for interim or annual periods beginning after December 15, 2005. Accordingly, we are required to apply SFAS No. 123(R) beginning January 1, 2006. SFAS No. 123(R) offers alternative methods of adopting this final rule. At the present time, we have not yet determined which alternative method we will use.

On March 3, 2005, the FASB issued Financial Interpretation No. ("FIN") 46(R), "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003) Variable Interest Entities an Interpretation of ARB No. 51." FIN 46(R) requires us to consolidate variable interest entities if we are designated as the primary beneficiary of that entity, even if we do not own a majority of voting interests. A variable interest entity is generally defined as an entity that has insufficient equity to finance its activities or the owners of the

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entity lack the risks and rewards of ownership. The provisions of FIN 46(R) had no impact on our results of operations or financial position.

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.

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, establishes accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset or a liability measured at its fair value. SFAS No. 133 also requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met, and that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting. We currently use derivatives to manage foreign currency rate risk.

One of our United Kingdom subsidiaries conducts business in British pounds sterling and has a program that utilizes forward currency contracts denominated in United States dollars to offset the risk associated with the effects of currency exposure for sales in United States dollars. Under this program, increases or decreases in the subsidiary's foreign currency exposure are offset by gains or losses on the forward contracts, to mitigate the

24

possibility of foreign currency transaction gains or losses. These forward contracts generally have terms of 90 days or less. We do not use these forward contracts for trading purposes. All outstanding foreign currency forward contracts used in this program are marked to market at the end of the period with unrealized gains and losses included in other income and expense.

Emrise Electronics also has a program that utilizes a forward currency contract denominated in British pounds sterling to offset the risk of intercompany loans to a United Kingdom subsidiary. Under this program, increases or decreases in the current portion of intercompany debt due to Emrise Electronics are offset by gains or losses on the forward contract, to mitigate the possibility of foreign currency transaction gains or losses. The forward contract currently expires in August 2005. We do not use this forward contract for trading purposes. The forward contract used in this program is marked to market at the end of the period with unrealized gains and losses included in other income and expense.

Our ultimate realized gain or loss with respect to currency fluctuations will depend on the currency exchange rates and other factors in effect as the contracts mature. Net foreign exchange transaction losses included in other income and expense in the accompanying consolidated statements of operations totaled \$36,000 for the six months ended June 30, 2005. There was no hedging in the year ended December 31, 2004.

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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 annual report on Form 10-K for the year ended December 31, 2004 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, 2005.

ITEM 4. CONTROLS AND PROCEDURES.

On August 15, 2005, in connection with its review of our condensed consolidated financial statements for the quarter ended June 30, 2005, Grant Thornton LLP, our independent registered public accounting firm, advised our management of a matter that Grant Thornton LLP considers to be a "material weakness" as that term is defined under standards established by the Public Company Accounting Oversight Board (United States).

Grant Thornton LLP noted that we recorded revenue in our Pascall division for certain items previously recorded as "bill and hold" inventory. We had shipped the items to the customer on June 30, 2005, the customer took title to the items and paid for the items. However, the customer requested that Pascall store the items and returned the items to Pascall on July 7, 2005 for storage under a separate contract. The return of the items by the customer subsequent to June 30, 2005 resulted in the transaction not meeting the revenue recognition criteria under Staff Accounting Bulletin ("SAB") No. 104. The recording of these items as sales in the quarter ended June 30, 2005 resulted in an adjusting journal entry to reduce revenue by \$841,000 and to reduce net income by \$314,000 (\$0.01 per share). On August 18, 2005, Grant Thornton LLP met with our audit committee and recommended that we review the control procedures over bill and hold arrangements to determine adherence to SAB 104. Our audit committee and management have undertaken an extensive review of SAB 104. We are seeking guidance from our financial consultants, who are certified public accountants with the requisite background and experience, to assist us in our future compliance with SAB 104 as it relates to control procedures over bill and hold matters.

25

Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) have concluded that the design and operation of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act")) were not effective as of June 30, 2005 with respect to the material weakness identified in the area of control procedures over bill and hold arrangements.

During the quarter ended June 30, 2005, there were no changes in our "internal controls over financial reporting" (as defined in Rule 13a-15(f) under the Exchange Act) that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

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

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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 Wells Fargo Bank, N.A., 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.

On May 6, 2005, we held a special stockholders' meeting. The total number of outstanding votable shares was 37,334,705. Our stockholders were asked to consider and vote upon the following three proposals:

(1) Amendment of our certificate of incorporation in order to increase our authorized common stock from 50,000,000 shares to 150,000,000 shares and make clarifying changes.

(2) Amendment of our certificate of incorporation in order to clarify the mechanics of our classified board.

(3) Amendment and restatement of our certificate of incorporation in order to modernize and conform the certificate of incorporation to current Delaware corporate law and practices.

26

Proposal -----	For ---	Against -----	Withheld -----	Total Voted -----
(1)	29,541,554	1,397,690	30,513	30,969,757
(2)	21,478,130	810,286	46,010	22,334,426
(3)	21,947,419	354,004	33,003	22,334,426

As a result, proposals 1 and 3 were approved by our stockholders. Due to the supermajority voting requirement that applied to proposal 2, proposal 2 did not receive sufficient affirmative votes for approval.

We filed an amended and restated certificate of incorporation with the Secretary of State of Delaware on May 9, 2005 to reflect the stockholders' approval of proposals 1 and 3.

ITEM 5. OTHER INFORMATION.

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None.

ITEM 6. EXHIBITS.

Number -----	Description -----
3	Amended and Restated Certificate of Incorporation of Emrise Corporation filed with the Secretary of State of Delaware on May 9, 2005 (1)
31	Certifications 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

(1)	Filed on May 19, 2005 as an exhibit to our Form 8-K for May 6, 2005 and incorporated herein by reference.

27

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: August 22, 2005

By: /S/ CARMINE T. OLIVA

 Carmine T. Oliva, Chairman of the Board,
 Chief Executive Officer (principal executive
 officer) and President

By: /S/ RANDOLPH D. FOOTE

 Randolph D. Foote, Chief Financial Officer
 (principal financial and accounting officer)

28

EXHIBITS ATTACHED TO THIS REPORT

EXHIBIT NUMBER -----	DESCRIPTION -----
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- 31 Certifications 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